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# *ESTATE WISE PLANNING*<sup>TM</sup>

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**“Estate Tax Return:”** What does the expression “estate tax return” mean? Recently, a decedent’s personal representative (executor/executrix) contacted me and inquired if she is required to file an “estate tax return” for the decedent’s estate. Evidently, her attorney suggested an “estate tax return” may be required. Her question may have been one of a first impression. By “estate tax return,” did her attorney mean a United States Estate and (Generation-Skipping Transfer) Tax Return (Form 706), the purpose of which is to report federal estate tax that may be due; an Oregon Inheritance Tax Return (Form IT-1) to report to the Oregon Department of Revenue any “inheritance tax” due; a U.S. Income Tax Return for Estates and Trusts (Form 1041) to report federal income tax due on income received by the decedent’s estate following the decedent’s date of death; or an Oregon Fiduciary Income Tax Return (Form 41) to report State of Oregon income tax due on income received by the decedent’s estate after the decedent’s date of death? To the lay person, all four forms might be considered “estate tax returns.”

It’s important to understand that, even after a person has died, his or her *estate* may become a taxpayer; *i.e.*, the *estate* becomes a separate legal entity for both federal and state income tax purposes. A decedent’s *estate* comes into existence at the time of an individual’s death. Thus, an *estate* may become a taxable person, just as individuals are taxable persons. In this regard, IRC §7701(a)(1) provides: “The term *person* shall be construed to mean and include an **individual**, a **trust**, **estate**, partnership, association, company or corporation.” [Emphasis added] Hence, the decedent’s *estate* may be required to file an *estate* (or *fiduciary*) income tax return [Form 1041 and Form 41 (for Oregon residents and nonresidents having estates in Oregon)].

Form 706 must be filed if the value of the decedent’s *gross estate* exceeds \$3.5 million (federal estate tax exemption amount in 2009) [IRC §6018(a)(1)]. A Form IT-1 must be filed if the value of the decedent’s *gross estate* is equal to or greater than \$1.0 million [ORS 118.160(1)(b)(D)]. In general, a Form 1041 must be filed by the decedent’s personal representative (or administrator), if the decedent’s *estate* is subject to probate and such domestic estate has: (1) gross income for the tax year of \$600 or more or (2) a beneficiary who is a nonresident alien. If the decedent died with a revocable living trust, the trustee must file a Form 1041 for a domestic trust [(*e.g.*, a revocable living trust following the death of the trustor, an irrevocable living trust both during the lifetime of the trustor and after the trustor’s death or a testamentary trust)] under IRC Section 641 that has: (1) any taxable income for the year; (2) gross income of \$600 or more (regardless of taxable income); or (3) a beneficiary who is a nonresident alien [IRC §6012(a)(4) or (5) and (b)(4)]. An Oregon Form 41 must be filed by the decedent’s personal representative for: (1) Oregon resident estates or trusts required to file a federal Form 1041 or 990-T; (2) all estates and trusts upon termination to report the final distribution to beneficiaries; (3) ancillary (out-of-state) Oregon estates with federal

gross income of \$600 or more for the tax year; (4) nonresident estates with federal gross income of \$600 or more from Oregon sources for the tax year; (5) all estates that want to establish a fiscal tax year, even if the estate had less than \$600 of federal gross income for the tax year; (6) part-year resident trusts with federal gross income of \$600 or more from Oregon sources for the tax year; and (7) nonresident trusts with federal gross income of \$600 or more from Oregon sources for the tax year [Form 41, page 1 (Rev. 10-08); ORS 316.362(1)(c), (d) and (e) (2001)].

**Observation:** When it is stated that “a decedent’s *estate* comes into existence at the time of an individual’s death,” in general, such a statement means the decedent’s *probate estate*. In general, a decedent’s *nonprobate estate* is not required to file either a Form 1041 or an Oregon Form 41. This is true, since the decedent’s beneficiaries receiving property outside the decedent’s Last Will would be responsible for reporting any income attributable to assets received as a beneficiary of contract benefits, payable-on-demand (“POD”) accounts, transfer-on-death (“TOD”) accounts or a surviving joint tenant of assets (property) titled in the name of the decedent and the surviving joint tenant(s) with right of survivorship, including tenants by the entirety with right of survivorship. Exceptions to this general rule are discussed below.

The personal representative who contacted me represented that, as of the date of the decedent’s death, the value of the decedent’s *gross estate* was less than \$1.0 million and that, following the decedent’s death, interest had accrued on a money market fund and the personal representative sold the decedent’s real property for a price equal to the value of the property included in the decedent’s *gross estate*. Given these representations, a Form 706 is not required to be filed, since the federal estate tax exemption amount is \$3.5 million (\$2.0 million in 2008, the year of the decedent’s death); and a Form IT-1 (Oregon Inheritance Tax Return) is not required to be filed, since the value of the decedent’s *gross estate* for purposes of the Oregon “inheritance” tax was less than \$1.0 million. Form 1041 and Oregon Form 41 may be required to report the estate’s interest income on the money market account and the capital gain or loss from the sale of the real property.

For example, if the decedent’s money market account was held by the decedent and another person as joint tenants with right of survivorship (“JTWROS”), then, the money market account would be part of the decedent’s *nonprobate estate* (such property would not pass under the terms of the decedent’s Last Will; hence, it would be part of the decedent’s *nonprobate estate*). In such case, the surviving co-tenant would be responsible for including the interest income from the account on his or her Form 1040 after the date of the decedent’s death to the end of the tax year in which the decedent’s death occurred. The decedent’s personal representative (or the surviving spouse of the decedent or the decedent’s surviving partner under a State of Oregon registered domestic partnership) would include the decedent’s share of the money market interest on the decedent’s Form 1040 to the date of death for the taxable year in which the decedent’s death occurred. Similarly, if the money market account was “payable on death” to a named beneficiary, the value of the money market account would be included in the decedent’s *nonprobate estate*. Further, assume that the decedent and another person owned the real property as JTWROS. In such case, as with the money market account, the real property would be part of the decedent’s *nonprobate estate*. Upon the decedent’s death, legal title to the real property would vest in the surviving co-tenant. Hence, upon a sale of the real property by the surviving co-tenant, it would be the co-tenant’s responsibility—not the estate of the decedent—to report any capital gain realized on the sale on his or her Form 1040.

On the other hand, if the money market account and the real property were, for example, titled in the name of the trustee of the decedent’s revocable living trust, grantor retained annuity trust (GRAT), grantor retained unitrust (GRUT), grantor retained income trust (GRIT), personal residence trust (PRT), qualified personal residence trust (QPRT), irrevocable living life insurance trust (ILIT), or distributable to a testamentary trust, then, upon the decedent’s death, Forms 1041 and 41 may be required, since the *trust* becomes a new tax entity; *i.e.*, the *trust* becomes a new tax person. In this regard, the income tax imposed by IRC Section 1(e) “...shall apply to the taxable income of *estates* or of any kind of property held in trust...” [IRC §641(a)] [Emphasis added]

Again, however, if the money market account and the real property are titled in the name of the trustee, those assets are part of the decedent’s *nonprobate estate*; and the trustee of the revocable living trust would report any income of the *trust estate* following the date of the decedent’s death on Form 1041 and Oregon Form 41. My recommendation

was that the personal representative who contacted me inquire of her attorney what she meant by “estate tax return;” *i.e.*, did she mean an *estate* “estate tax return” (Form 706), *estate* “inheritance tax return” (*e.g.*, Oregon Form IT-1) or *estate* “income tax return” (Form 1041 or, *e.g.*, Oregon Form 41)?

**Observation:** Though the remainder value in a charitable remainder trust (CRT) may be includable in the noncharitable beneficiary decedent’s *nonprobate estate*, a CRT does not file a Form 1041 nor an Oregon Form 41. Instead, a CRT files a Form 5227, Split-Interest Trust Information Return. If the CRT has any unrelated business taxable income (UBI), it must also file Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code. If Form 5227 is required for federal income tax, a copy of that form is filed with the Oregon Department of Revenue. Do not attach a Form 41 to the Form 5227. Mark the copy of Form 5227 “Oregon Information Copy.”

**Form 706 Availability:** As of September 24, the IRS has not made available revised Form 706 (*i.e.*, for decedents dying after December 31, 2008, and before January 1, 2010). A Form 706 for a decedent dying on January 1, 2009, would be due October 1, 2009. The prospective release date for revised Form 706 was September 11, 2009. However, my office has been informed that the prospective release date for revised Form 706 has been pushed back to “sometime in October 2009.” For decedents in a state, such as Oregon, that requires the appropriate schedules of Form 706 to be attached to the state inheritance tax (or estate tax) return, a delay in the release of Form 706 could present an interesting conundrum for the timely filing of a state inheritance tax (or estate tax return), as well as for the Form 706, if the decedent’s federal *gross estate* is greater than \$3.5 million.

Rumor has it that Congress may effect a “patch” regarding the federal estate tax for the year 2010 (the federal estate tax and generation-skipping transfer tax are repealed for decedents dying after December 31, 2009) [IRC §§2210(a) and 2664]. If so, the IRS may be reluctant to have printed a revised Form 706 effective for just one year. Instead, the IRS may be anticipating the “patch,” in which event, a revised Form 706 may include reporting of estates for decedents dying after December 31, 2008, and before January 1, 2011. Under present law, for decedents dying after December 31, 2010, the federal estate tax applicable exclusion amount (“exemption amount”) would revert to \$1.0 million and a maximum estate tax rate of 55 percent (*i.e.*, the exemption amount and estate tax rates in effect for decedents dying after December 31, 2001).

The Oregon Department of Revenue has advised me that, if the decedent’s estate is required to file an Oregon Inheritance Tax Return (Form IT-1, to be filed if the value of the decedent’s gross estate is equal to or greater than \$1.0 million), but is not required to file a Form 706 (*i.e.*, the value of the decedent’s gross estate is equal to or less than \$3.5 million), then, the ODR will accept the now out-dated Form 706 to be attached to the Form IT-1. In any event, practitioners, personal representatives and trustees would be well-advised to file IRS Form 4768 [Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes for federal estate tax returns and for states that accept Form 4768 when filing for an extension of time to file and/or pay state inheritance or estate tax] to avoid late filing and/or payment penalties.

**Estate Planning Common Mistakes:** Misconceptions about estate planning contribute to mistakes made in estate planning. Since 1979, as a fee-paid specialist in estate/gift taxation and planning, this author has yet to review in the initial get-acquainted interview a person’s existing Last Will and trust that would carry-out the person’s estate plan as intended. Many reasons exist for this truism; yet, the majority of the reasons can be attributed to often-repeated common mistakes. Following are two common mistakes most often made:

**Incorrect Beneficiary Designations of Contract Benefits.** Incorrect beneficiary designation of employer-provided and personal contract benefits is another common mistake. Designating the wrong beneficiary of a contract benefit [*e.g.*, qualified plan benefits, 401(k) plans, SEPs, IRAs, Keogh plans, nonqualified deferred compensation plans, salary continuation benefits, survivor benefits, group term life insurance, personal individual life insurance] can have the same effect as owning property jointly with right of survivorship. In situations involving married persons, too much property may be eligible for the estate tax marital deduction in the estate of the first decedent spouse, resulting

in overexposure of this property to estate tax (or state inheritance or estate tax) in the estate of the surviving spouse. Moreover, such property is part of the decedent's *nonprobate estate*, thereby, making it challenging if not, in some cases, impossible to fund trusts with the decedent's interest in such property, since the designated beneficiary receives such property outside the decedent's Last Will or trust.

**Life Insurance Ownership.** Life insurance is one of the most valuable assets available to the estate owner. Yet, its importance in providing liquidity and a source of funds for a variety of purposes is greatly misunderstood and disregarded. Mistakes are frequently made regarding the ownership and beneficiary designations of life insurance policies in relation to other assets composing a person's estate. Furthermore, violating the life insurance policy transfer-for-value rules can subject the beneficiary of the life insurance proceeds to unnecessary income tax. Further, if an irrevocable life insurance trust (ILIT) is to be the owner, premium-payer and beneficiary of a second-to-die (*i.e.*, survivorship life insurance) policy, then, it is critical that such a trust be correctly designed to be the owner and beneficiary of such an insurance policy(ies).

**Question of the Month:** How do I keep track of new investments or additional assets after I have already effected a revocable living trust? **Answer:** By adding a description of the new property to the appropriate schedule attached to the trust or by effecting a Trustee's Acceptance of Property Conveyed to Trust Agreement (see file "APP0902.DOC" in my book, *Living Trusts: Third Edition, John Wiley & Sons, Inc., Copyright © 2003 by Doug H. Moy*, all rights reserved).

**AFR:** The **September 2009** Applicable Federal Rate, under IRC Section 7520, for determining the present value of an annuity, an interest for life or a term of years or a remainder or reversionary interest is **3.4 percent** [Rev. Rul. 2009-22, 2009-31 I.R.B.1, Table 5]. The **October 2009** AFR is **3.2 percent** [Rev. Rul. 2009-33, 2009-40 I.R.B.1, Table 5]. This bodes well for the grantor retained annuity trust (GRAT), charitable lead annuity trust (CLAT), charitable transfer of remainder interest in residence or farm and private annuities but not well for the qualified personal residence trust (QPRT), grantor retained income trust (GRIT) and charitable remainder annuity trust (CRAT). Lower AFRs have no impact on grantor retained unitrust (GRUT), charitable remainder unitrust (CRUT), charitable lead trust (CLT) and pooled income funds. **Note:** In the case of transfers to a CRAT for which the *valuation date* is **after** April 30, 1999, if an election is made under IRC Section 7520 and Treasury Regulation Section 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for **either of the two months preceding the month** in which the transfer is made, the month so selected is the *valuation date* for purposes of determining the interest rate (*i.e.*, the AFR) and mortality tables [Treas. Reg. § 1.664-2(c) (Jan. 5, 2001)]. In other words, one may choose the lowest AFR of either of the two months preceding the month the CRAT is funded in order to obtain the maximum tax deduction for the present value of the remainder interest.

[**Note:** Section 6110(k)(3) of the Code provides that letter rulings may not be used or cited as precedent; however, they may be cited as authority].

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