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Estate Planning with Retirement Benefits under the SECURE Act

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Thankfully, every one of our communities is now set up for retirement enhancement.

The SECURE Act of 2019 (Setting Every Community Up for Retirement Enhancement), effective as to deaths of retirement plan and IRA participants and designated beneficiaries after December 31, 2019, substantially changes the income tax treatment of plan benefits after the death of the owner and owner's spouse. SECURE accelerates distributions from inherited IRAs: only a few classes of beneficiaries may "stretch out" plan distributions over their lifetimes, but most will have to distribute the entire balance within 10 years. SECURE does, however, provide some "enhanced" income tax benefits during the lives of the owner and surviving spouse.

This article refers generally to both defined contribution plan accounts and IRAs as "IRAs," and employees, participants, and owners as "owners." This article does not deal with defined benefit plans, and ignores rules for disabled or chronically ill beneficiaries.

SECURE During Lives of Owner and Spouse

Delayed RBD. SECURE delays the required beginning date ("RBD") for required minimum distributions ("RMDs") to April 1st of the calendar year after the year in which the owner reaches age 72 (increased from 70 ½). Owners reaching 70 ½ during 2019 will reach their RBD on April 1, 2020 and those reaching 71 ½ in 2020 will reach their RBD on April 1, 2022. Therefore, no RBDs will occur in 2021. In addition, the CARES Act waives RMDs for 2020, as discussed below.

Extended Deductible Contributions. SECURE allows owners to make tax-deductible contributions for an owner's entire lifetime (prior law excluded deductions after age 70 ½). Contribution qualifications are unchanged.

QCDs. SECURE only slightly changes the Qualified Charitable Distribution ("QCD") rules. Direct charitable contributions are still permitted after age 70 ½ under existing rules. However, QCDs are reduced by the amount of any tax-deductible contributions made after 70 ½.

Spousal Rollover, Alternatives. The spousal rollover opportunity remains unchanged. If the surviving spouse was named outright as primary beneficiary, then a surviving spouse may still elect to "roll over" a deceased spouse's IRA and make it the surviving spouse's own IRA. Also, if the surviving spouse was named as primary beneficiary, the spouse may elect to receive the IRA as an inherited IRA as an Eligible Designated Beneficiary ("EDB," defined below). If a bypass or other marital trust is substituted for the deceased spouse, that

In This Issue

1 Estate Planning with Retirement Benefits under the SECURE Act

7 Brief Overview and Results of Inconsistent Alternate Date Valuation Elections under IRS § 2032 and ORS 118.010(8)

trust will be an EDB if structured as a conduit trust, but otherwise will be a Designated Beneficiary ("DB") or No Designated Beneficiary ("NDB").

CARES Act

The CARES Act of 2020 (Coronavirus Aid, Relief, and Economic Security Act), effective as of March 27, 2020, provides the following opportunities for individuals with retirement plans to counteract the negative economic impact of the Coronavirus pandemic.

- The due date for IRA contributions and plan contributions for 2019 is extended to July 15, 2020 (applicable to all taxpayers, not only "coronavirus-related" individuals).
- RMDs are waived for both 2019 RMDs required by April 1, 2020 and for 2020 RMDs, for anyone who is required to take an RMD, not just coronavirus-related individuals. The waiver applies to owner or beneficiary distributions, and is limited to certain defined contribution plans, including 401(k), 403(b), 457(b) plans, and IRAs. The waiver does not appear to apply to RMDs taken prior to 2020, and does not change the RBD.
- An owner of any age may take distributions ("coronavirus-related distributions," or "CRDs") up to $100,000 from qualified retirement accounts for coronavirus-related purposes in 2020 without paying the 10 percent early withdrawal penalty. Income attributable to those distributions would be subject to tax over the following three years, and the owner may avoid the tax by recontributing the funds to an eligible retirement plan within three years (not subject to annual contribution cap).
- In addition, an owner may take loans up to $100,000 from certain retirement plans for coronavirus-related relief. With a 401(k) loan, the owner will not owe income tax on the amount borrowed if the loan is paid back within five years. But if the owner's employment is terminated prior to repayment the owner may be required to either pay back the balance early or pay tax on the loan as a distribution, and may be subject to an early-withdrawal penalty.
- "Coronavirus-related" means an individual:
  - who is diagnosed with COVID-19,
  - whose spouse or dependent is diagnosed with COVID-19, or
  - who experiences adverse financial consequences as a result of being quarantined, furloughed, or laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reduced hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary.

SECURE after Deaths of Owner and Spouse

Limits to "Stretch-Out." IRA distributions after the death of the owner prior to 2020 could be paid out to an individual DB over the beneficiary's life, in annual withdrawals based on the beneficiary's remaining life expectancy. This rule allowed beneficiaries of deceased owners to "stretch out" RMDs in annual payments over their lifetimes, after the owner had already stretched them out for his or her lifetime, providing decades of income tax deferral. SECURE continues to allow the stretch-out for surviving spouses and a few other EDBs, but for other beneficiaries lifetime stretch-out is replaced with a 10-year distribution requirement.

Three Classes of Beneficiary. SECURE creates three classes of IRA beneficiary: DB, NDB, and EDB. The RMD schedule applicable to a beneficiary after the owner's death will depend on the beneficiary's class and whether the owner had reached his or her RBD.

Designated Beneficiary (DB) – the 10-Year Rule. SECURE does not change the definition of "designated beneficiary," except that EDBs are added as a special class of DB (in these materials reference to "DB" means a DB who is not an EDB). But SECURE does change the effect of having a DB. The entire IRA must be distributed to the DB within 10 years of the owner's death (the "10-year rule"). Under the 10-year rule:

- Distributions need not be paid annually; instead, distribution of the entire IRA can be delayed until the last day of the 10-year period.
- Note the tax bracket trap: consider the effect of higher income tax brackets if the entire IRA balance is paid in a taxable lump sum in one year, compared to smaller annual payments over a number of years.
- The 10-year period ends on the last day of the calendar year that is 10 years after the year of the owner's death, potentially extending the 10-year period to 11 years (if the owner died January 1, 2020, the 10-year period would end December 31, 2030).
- Generally a DB must be an individual, but, as discussed below, certain trusts, generally referred to as "see-through" trusts, may also qualify as DBs.

Death of DB. Upon the death of a DB prior to the end of the 10-year period, the remainder the of 10 years is not accelerated or forfeited, nor does the 10-year clock restart;

instead, the DB's beneficiaries can continue to defer distributions until the end of the original 10-year period (generally a DB can name a "secondary beneficiary" to take the remainder of the DB's term and distributions if the DB does not survive the 10 years and had not distributed the entire IRA prior to the DB's death; if no such secondary beneficiary is designated, the distributions may default to other named beneficiaries or to the DB's estate, depending on IRA contract terms and/or applicable laws of descent).

No Designated Beneficiary (NBD) – the Five-Year Rule. If no beneficiary is named, or if a named or default beneficiary does not meet the definition of a DB, then the IRA is deemed to have NDB. SECURE does not change the RMD schedule for NDBs: if the owner had not yet started RMDs, the IRA balance must be paid out within five years of the owner's death (annually or lump sum), or, if the owner had started RMDs, the IRA balance must be paid out over the owner's remaining life expectancy (annually). Examples of an NDB include the owner's estate, a non-see-through trust, and a corporation or other entity, such as a nonprofit.

- The possibility of distributions over the owner's remaining life expectancy for NDBs, compared to the 10-year rule for DBs, creates a presumably unintended planning consideration. If an owner died after his or her RBD, but at death had a remaining life expectancy of more than 10 years, an NDB would have a longer deferral period than a DB. The NDB, however, would be required to take annual distributions, while the DB could take lump sums. Under age 81, an owner would have more than 10 years remaining life expectancy. See the Single Life Table under Treasury Regulation § 1.401(a)(9)-9, applicable to inherited IRAs. Note that some practitioners have suggested that SECURE should be interpreted to allow a DB to take distributions like an NDB if the owner reached his or her RBD.
- Changes in beneficiaries during the five-year period do not affect the five-year period; e.g., any secondary beneficiaries may defer only for the remainder of the initial five-year period.

Eligible Designated Beneficiary (EDB) – Full or Partial Stretch-Out. SECURE creates a new and special class of DB, called an Eligible Designated Beneficiary (EDB). An EDB is entitled to stretch-out distributions based on the EDB's remaining life expectancy, paid annually, so long as the EDB qualifies as an EDB. An EDB must be one of the following five beneficiaries: (1) owner's surviving spouse; (2) owner's surviving minor child; (3) beneficiary less than 10 years younger than owner; (4) disabled beneficiary; (5) chronically ill beneficiary.

- Generally, an EDB must be an individual; however, as discussed below, certain "conduit" trusts may also qualify as EDBs. Certain "accumulation" trusts for disabled or chronically ill individuals may also qualify as EDBs, but this article does not address planning for disabled or chronically ill beneficiaries.
- For minor child beneficiaries, there is no "move up" rule as may apply for GST tax purposes. If an owner's child predeceases the owner, that child's child (owner's grandchild) will not be treated as the owner's minor child and qualify as an EDB, but instead will be a DB.

Death of EDB, Termination of EDB Status. Upon the death of an EDB (spouse, minor child, or 10-year younger beneficiary), the subsequent (secondary) beneficiary must receive the entire IRA within 10 years under the 10-year rule.

- It appears that the 10-year rule applies upon the death of an EDB, whether the secondary beneficiary qualifies as a DB or NDB or EDB, although this point is not entirely clear under the statute. If so, the deferral period after the EDB's death could be different than the deferral period after the owner's death: after the owner's death the deferral period could be 10 years (DB), five years (NDB), or life plus 10 years (EDB); after an EDB's death the deferral period (presumably) will always be 10 years.
- The 10-year period ends on the last day of the calendar year that is 10 years after the year of the EDB's death (meaning, like after the death of an owner, the 10-year period could be 11 years).
- Upon reaching age 18 (in Oregon), a minor EDB will cease to be an EDB, and the EDB's 18th birthday is like the date of the EDB's death: the 10-year rule will apply to the (now adult) beneficiary, with the 10-year period ending the last day of the year that is 10 years after the year the beneficiary reaches 18. The age of majority can be extended to age 26 as long as the child is pursuing a "specified course of education" (see more on this detail below). "Specified course of education" is a broad term yet to be defined.

Death of Owner Prior to SECURE, Death of Beneficiary After SECURE. Regarding a pre-SECURE inherited IRA: if an IRA owner died before 2020, SECURE does not apply to the IRA beneficiary. Instead, the beneficiary receives RMDs based on the beneficiary's

life expectancy under pre-SECURE rules. However, if the IRA beneficiary subsequently dies after 2019, then SECURE does apply to the next beneficiary (the secondary beneficiary described above), and in that case the secondary beneficiary is subject to the 10-year rule, commencing upon the prior (primary) beneficiary's death.

- The statute is somewhat unclear on this point. Perhaps the better reading of the statute is that the death of a pre-SECURE inherited IRA beneficiary after 2019 is treated like the death of an EDB, meaning that the 10-year rule applies after the beneficiary's death whether the secondary beneficiary is a DB, EDB, or NDB. This may be an item for regulatory clarification or correction.

Trusts as Beneficiaries

Trust as DB, EDB, or NDB. Generally, only an individual can be a DB or EDB, meaning that naming a trust as beneficiary would result in an NDB. However, as under pre-SECURE law, certain trusts may be treated as "see-through" trusts – the law sees through the trust and will treat the trust as a DB or EDB if certain individual trust beneficiaries qualify as a DB or EDB. As under prior law, these trusts are known as either "conduit" trusts or "accumulation" trusts. The terms of those trusts will determine whether the trust qualifies as a DB or EDB, and thereby also determine applicable RMD deferral periods. The see-through qualification rules are unchanged by SECURE, but the results of qualification are changed – only conduit trusts for EDBs (not DBs) (and accumulation trusts for disabled or chronically ill individuals) will qualify for life expectancy-based RMDs; other conduit trusts and accumulation trusts will be limited to the 10-year rule.

Conduit Trusts. A "conduit trust" is a trust which requires that all distributions from the IRA to the trust, including all RMDs, be promptly distributed to one individual who is a beneficiary of the conduit trust (that individual could be called the "conduit beneficiary"). The conduit trust might include other beneficiaries, but the conduit beneficiary must receive all IRA distributions, and no IRA distributions can be retained (accumulated) in the trust. For purposes of calculating RMDs, the conduit beneficiary (who is a trust beneficiary, not the IRA beneficiary – the trust is the IRA beneficiary) is treated as being the IRA beneficiary.

- Therefore, if the conduit beneficiary is a DB the RMD will be the 10-year rule. If the conduit beneficiary is an EDB, the RMD will be stretched out over the beneficiary's life, followed by a 10-year rule period.
- A conduit trust subject to the 10-year rule creates two big problems. The first is an asset protection planning problem. With a lifetime stretch-out RMD, a spendthrift beneficiary will only have access to limited annual income. However, with a 10-year rule RMD, the beneficiary will receive the entire fund within 10 years. The second is an income tax bracket planning problem. The shorter RMD will result in larger payments each year, perhaps even the entire fund in one year, which may push the conduit beneficiary into higher income tax brackets than under a lifetime stretch-out.

Death of Conduit Beneficiary. The death of the conduit beneficiary would be treated like the death of a DB (above); however, the secondary beneficiaries would be identified by the conduit trust agreement, rather than by the IRA beneficiary designation.

Conduit Trusts for Multiple or Successive EDBs. SECURE is silent on the treatment of a beneficiary designation naming multiple or successive EDBs, or naming a conduit trust with multiple or successive EDBs as beneficiaries. Presumably SECURE, like prior law, would essentially ignore all but the eldest initial EDB in determining the RMD schedule. In general, under SECURE and prior law, naming multiple beneficiaries or a trust with multiple beneficiaries will not produce optimum results, and instead IRA owners should create separate shares for each EBD to ensure each receives the maximum lifetime stretch-out.

Accumulation Trusts. An accumulation trust is a trust beneficiary of an IRA which does not require that RMD payments be immediately distributed to a conduit beneficiary. Estate planners have previously approached accumulation trusts with great caution, and prior to SECURE many estate planners may have never actually drafted an accumulation trust for fear of failing to obtain the longest stretch-out period for that trust. SECURE eliminates that concern, and planners should now consider accumulation trusts standard tools to be considered in every beneficiary designation analysis.

- Because an accumulation trust is not a conduit trust, an accumulation trust may qualify as a DB, but never as an EDB (other than for the benefit of certain disabled/chronically ill individuals). Therefore, an accumulation trust, as a DB, will not qualify for lifetime stretch-out, meaning that a drafter's failure to maximize the stretch-out under an accumulation trust is no longer a risk in most cases. Under SECURE, the only concern is whether the accumulation trust qualifies as a DB.
- The qualification rules remain unchanged: (1) all trust beneficiaries, even "potential beneficiaries," must be individuals, but the trust may include

non-individual beneficiaries if they are "mere successor potential beneficiaries;" (2) if the beneficial interests of all beneficiaries not entitled to outright distribution of IRA distributions were terminated, a then-living individual must be entitled to outright distribution of all future IRA distributions (essentially, an accumulation trust must have one or more "contingent conduit beneficiaries" who survive the owner and would be entitled to outright distribution of all IRA distributions if all preceding beneficial interests had terminated at the owner's death); (3) a "mere potential beneficiary" is a beneficiary whose interest is subsequent to and contingent upon the interest of the contingent conduit beneficiary.

- Example: individuals A and B survive owner. (1) trust provides for lifetime discretionary distributions to A, then to B if B survives A, then to charity C – trust does not qualify as an accumulation trust because no individual would be entitled to outright distribution if A and B did not survive owner. (2) trust provides for lifetime discretionary distributions to A, then outright distribution to B if B survives A, or if B does not survive A to C – trust qualifies because if A did not survive owner, B would be entitled to outright distribution.

<u>*Income Tax Problems with Accumulation Trusts*</u>. An accumulation trust is generally a better asset protection tool than a conduit trust, because the trustee is not required to make distributions to beneficiaries. However, IRA distributions to the trust that are not distributed to trust beneficiaries will be taxed at the trust's higher income tax brackets. Any spendthrift trust risks bracket compression if income is not distributed, but because the entire amount of an IRA distribution is taxable as ordinary income, non-IRA trusts generally have much lower income than an IRA trust. The trustee will have to balance bracket compression against spendthrift behavior.

- In addition, distribution standards under an accumulation trust (HEMS for example) may not permit large distributions to cause RMDs to be taxed to individual beneficiaries. Consider giving trustees discretion to make distributions for tax-planning purposes.
- If a conduit trust cannot qualify as an EDB, it is hard to see why a conduit trust would be used instead of an accumulation trust. An accumulation trust gives the trustee the option to pay IRA distributions to beneficiaries, but allows the trustee to accumulate those distributions for asset protection purposes. A conduit trust provides no better income tax results but greatly restricts the trustee's distribution options.

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Minor Beneficiaries

<u>*Options*</u>. Naming a minor child of an owner as a beneficiary of an IRA presents planning alternatives.

- *Name child directly* (presumably controlled by guardian/parent until age 18). A minor child of an owner is an EDB until age 18 (and in some cases until age 26, as discussed above), and the RMD during that period is based on the child's remaining life expectancy and paid annually. Upon reaching age 18 the child becomes a DB, meaning the RMD schedule switches from the child's life expectancy to the 10-year rule. As a result, the maximum deferral for a minor child will be to age 28 (or 29 in the 11-year scenario, or 36 if the child remains in a specified course of education until age 26), and upon reaching age 18 the child will have access to and control of the entire fund.
- *Name a conduit trust for child*. A conduit trust for a minor child qualifies as an EDB until the child reaches age 18, and during that period annual RMD distributions must be paid out to the child.

Thereafter, the trustee can decline to receive IRA distributions until the end of the 10-year period, giving the trustee control until the child reaches age 28.

- *Name an accumulation trust for child*. The tax results are potentially very different from the first two options, depending on the age of the child. In any event, the maximum stretch-out will be 10 years from the owner's death. If the child is nearly 18 at that time, stretch-out will reach age 28. But if the child is much younger, the stretch-out period will be substantially shorter with the accumulation trust.

A Planning Solution. Many clients will find a conduit trust for minor children acceptable, since a conduit trust will provide optimum tax deferral plus trustee control until age 28. However, if the tax deferral value of lifetime stretch-out during the time of minority is limited, the added asset protection value of an accumulation trust may be preferable. Therefore, consider a beneficiary designation that is contingent on the child's age. For example, if the beneficiary is under age 15 or so (determine age based on value of remaining EDB deferral period), the IRA beneficiary could be a conduit trust, but otherwise the IRA beneficiary could be an accumulation trust with the child as beneficiary. Further consider that beneficiary designation taking into account the beneficiary's participation in a "specified course of education" which may extend the age of majority, and therefore the flip to the 10-year rule, to age 26.

Bypass Trust Funding

Oregon Considerations. Bypass trusts are relatively common in Oregon since the legislature refuses to allow portability. Many estates are concentrated in a few assets, particularly residences and qualified plan assets. An IRA can be used to fund an Oregon bypass trust, but consider the options for a surviving spouse.

- *Rollover*. Spousal rollover most likely provides the greatest income tax deferral, because after the spouse's life an EDB may be able to defer IRA distributions beyond the 10-year rule that would be applicable on the death of an EDB. However, the IRA becomes an asset of the spouse's taxable estate, and the spouse has the discretion to name subsequent beneficiaries.
- *Inherited IRA (EDB)*. If the spouse receives the IRA in the form of an inherited IRA rather than a spousal rollover, the spouse's RMDs will be calculated using the Single Life Table instead of the more favorable Uniform Life Table. Spouse controls successor (secondary) beneficiary designation. On the spouse's death, a 10-year rule will apply to secondary beneficiaries.
- *Bypass Trust as Conduit Trust (EDB)*. Same lifetime stretch-out as an inherited IRA, but spouse need not (but could) have the power to name successor beneficiaries. However, the conduit trust will be required to pay all IRA distributions to the spouse, thereby depleting the bypass trust, moving the distributed portions into the spouse's taxable estate, and to some extent defeating the purpose of the bypass trust. Again, on the spouse's death the 10-year rule would apply.
- *Bypass Trust as Accumulation Trust (DB)*. A bypass trust structured as an accumulation trust avoids a conduit trust's required distributions to the spouse, but if IRA distributions are not paid out to the surviving spouse they will be taxed at trust income tax brackets. An accumulation trust will be subject to the 10-year rule, and will permit no additional deferral after the 10-year period.

A Planning Solution. In some cases, an owner may not favor a spousal rollover because the owner wants to control the secondary beneficiary designation. Otherwise, the only reason not to use a rollover is to fund a bypass trust. Funding a bypass trust will involve comparing estate tax savings (increased by a bypass trust) to income tax deferral savings (decreased by a bypass trust), a calculation best left until after the owner's death. If the owner is willing to allow the spouse to control secondary beneficiary designations, the best option may be to name the spouse outright as the primary IRA beneficiary, and for the contingent beneficiary to name a QTIP-qualified conduit trust with the remainder to children outright or to separate share conduit or accumulation trusts for them, and rely on the surviving spouse's qualified disclaimer for funding.

CRT as Beneficiary

For owners with charitable intent and who desire a lifetime stretch-out for a non-EDB, naming a charitable remainder trust (CRT) as IRA beneficiary may be an ideal solution. A CRT is taxed as a charity, meaning IRA distributions to the CRT are not taxed. However, the income beneficiaries (typically individuals) will be taxed on distributions to them, when made, at their brackets, based on the character of income received by the CRT. CRT distributions can be made over the beneficiary's entire life, meaning that tax on IRA distributions is deferred and leveraged, but not avoided, except to the extent never distributed to the income beneficiary.

Upon the expiration of the CRT term, any remaining assets are paid tax-free to a charitable remainder beneficiary, and as a result it is unlikely that a CRT will

pay more to family members than a payout under the 10-year rule. However, to hedge against untimely deaths cutting the CRT term short, the CRT term can be extended for the lives of multiple (concurrent or successive) income beneficiaries, so long as all income beneficiaries survive the owner (the CRT cannot accommodate after-born beneficiaries).

A CRT also provides asset protection benefits. CRT assets are generally not available to beneficiaries' creditors until actually distributed to the beneficiary.

The owner's estate will receive an estate tax charitable deduction for the present value (at DOD) of the CRT charitable remainder interest. Consider how to apportion estate tax on the non-charitable portion.

Roth IRAs

DBs of Roth IRAs avoid the compressed income tax issues of traditional IRAs created by the 10-year rule. DBs must still take IRA distributions under the 10-year rule, but distributions are not taxable to the beneficiary upon receipt. SECURE provides an additional benefit for a DB of a Roth IRA – the entire Roth IRA may remain untouched for the 10-year period, thus allowing the account to grow tax free (whereas pre-SECURE the DB had to take RMDs from the account each year). Depending on the owner's tax bracket and the likely future tax bracket of the DB, SECURE may make Roth conversions more attractive.

Brief Overview and Results of Inconsistent Alternate Date Valuation Elections under IRS § 2032 and ORS 118.010(8)

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Prior to fears of the global pandemic fully reaching the United States, the Dow Jones Industrial Average was hovering around its all-time high. The headline to an article on CNBC.com on February 21, 2020, read, "Dow Drops more than 200 points, posts losing week as coronavirus fears resurface." On that day, the Dow Jones closed at 28,992.41, losing a mere .8%. Jump forward approximately one month later and a headline on CNBC.com read, "Dow sheds another 3% after coronavirus stimulus bill fails in Senate for a second time." On March 23, 2020, the Dow Jones closed 29% lower than its closing level on February 21, 2020. Such drastic fluctuation in the stock market could have a large impact on the amount of federal taxes due from an estate under 26 USC § 2001, or the amount of Oregon estate taxes under ORS chapter 118.

The value of a decedent's gross estate is determined by including the "value at the time of [the decedent's] death of all property, real or personal, tangible or intangible, wherever situated." § 2031(a). Assume a decedent died on February 21, 2020, with an estate that consisted solely of stock with a value of $1,400,000. Further, assume the decedent's stock value mirrored the gains and losses of the of the Dow Jones Industrial Average, and, six months after the decedent's date of death, the Dow Jones Industrial Average closed at 20,000 points (69% of its value on February 21, 2020). This would mean, for estate tax purposes, the decedent's estate would be deemed to have a value of $1,400,000 under § 2031(a), even though the estate's value is only $966,000 six months after the decedent's death, causing the estate to be subject Oregon estate taxes even though the value of the estate is now within the amount of the Oregon estate tax exemption. ORS 118.010.

In the situation highlighted above, an Oregon-only Alternate Valuation election ("AV election") under § 2032 and ORS 118.010(8) should be strongly considered. An AV election allows the executor of an estate to value the estate assets on the date that is six months after the date of the decedent's death. § 2032(a)(2). If any property is sold or otherwise distributed between the date of death and the alternate valuation date, such property is valued as of the date it is sold or otherwise distributed. § 2032(a)(1).

The section of the Internal Revenue Code that provides for an alternate valuation date was first enacted as a result of the stock market crash in 1929. Because of the drastic drop in the stock market, some people died wealthy but, by the time their estate could be fully administered, the estate tax owed was actually more than the value of the estate. To alleviate this problem, a provision was enacted in 1935 permitting an alternate valuation date election.

Several requirements must be met in order to make an AV election. First, an AV election can be made only if the election decreases the value of the gross estate. Treasury Regulation § 20.2032(b)(1). Second, the election must be made on all of the assets in the estate. § 20.2032(b)(1). In other words, an asset-by-asset approach is not allowed. Third, the election must decrease the estate's federal estate tax that is due. § 20.2032(b)(1). Therefore, if no federal estate tax is due, no election is allowed. Further, the AV election is not eligible for property that declines in value simply due to the passage of time. § 20.2032(a)(3). Examples of such property include vehicles and patents. Instead, property that declines in value merely due to the passage of time is valued on the decedent's date of death. § 20.2032(a)(3).

Because events occurring after the decedent's death may determine whether an estate tax is due, a protective alternate valuation date election may be made. See IRS Letter Ruling 201118013; § 20.2032-1(b)(2). Such after-death events normally involve a marital deduction and a subsequent disclaimer. For example, if a husband's estate plan left his entire estate to his spouse, no estate taxes would be owed on the transfer due to the unlimited marital deduction. § 2056(a). However, if the spouse disclaimed property to take advantage of the federal estate tax unified credit under § 2010, the decedent's estate would not receive the martial deduction, and then could be subject to estate tax. Therefore, with the protective AV election, the decedent's estate could still take advantage of an AV election if later events caused the decedent's estate to be subject to tax.

The executor makes the AV election on IRS Form 706 on page 2, part 3, line 1 for federal purposes, and on page 2, part 3, line 1 on Form OR-706 for Oregon purposes. Form OR-706 does not provide an option to indicate that the alternate valuation date election is for Oregon-only purposes, so the fiduciary filing the return may want to indicate so on the top of OR-706. The election must be made on a timely filed return, or on a return filed within one year of the time prescribed by law (including extensions) for filing. § 2032(d)(2). After the AV election is made, any reference to the value of property as of the decedent's date of death will be read as the value of the property as of the alternate valuation date. § 2032(b). Once made, the election is generally irrevocable, except that such election may be revoked on a subsequent return if the subsequent return is filed before the return's due date (including extensions). § 20.2032-1(b)(1).

Many estates are not eligible for the AV election because the estate's value does not exceed the federal estate tax exemption, thereby not allowing for a decrease in federal estate tax. This restriction would prevent an estate from making an AV election even if only Oregon estate taxes were due. However, ORS 118.010(8) permits estates to make a state-only AV election. There is no law directly on point, but presumably an estate may make an Oregon-only election if the Oregon taxable estate exceeds the $1,000,000 Oregon estate tax exemption, and the AV election has the effect of reducing the Oregon estate tax.

If an AV election is made, it will normally be made at the heirs' expense. An heir's basis in inherited property is the value of property on the decedent's date of death. §1014(a). However, § 1014(f) restricts the basis transferred under § 1014(a) from exceeding the final value for property that has been included in determining the federal estate tax owed. § 1014(f)(1)(a). This means, although the estate will benefit from paying no, or less, estate tax if an AV election is made, the heirs receiving the property will receive a lower income tax basis in the property, potentially causing the heirs to realize greater gains, and subsequently pay higher taxes, when the inherited property is eventually sold.

In addition to the lower basis, the heirs will have inconsistent bases in the property that received an Oregon-only AV election but not a federal election. Once the asset is sold by the heir, ORS 316.716 requires that, for Oregon income tax purposes, the federal taxable income must be either increased or decreased by the difference between the federal and Oregon bases in such property. The difference in income that results from the inconsistent federal and Oregon bases could be reported on line 8 as an addition or on line 14 as a subtraction on Form OR-40 (Individual Income Tax Return), and on Schedule 2 of Line 10 on Form OR-41 (Oregon Fiduciary Income Tax Return).