SHOULD A FEDERAL ESTATE TAX RETURN BE FILED IN SITUATIONS WHERE THERE IS NO TAX DUE?

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ABSTRACT

Federal statutes require an estate tax return when a gross estate exceeds the exemption equivalent ($2 million for 2008; $3.5 million for 2009), even if the entire estate passes to a surviving spouse, resulting in a taxable estate of zero due to the unlimited estate tax marital deduction. Since there is no estate tax, the primary tax consideration is the income tax basis (generally fair market value under current law). Many commentators argue that no return is required. This paper presents both sides of this issue and explores whether not filing when there is no perceived benefit is acceptable, considering (1) the financial aspects, (2) professional ethics, and (3) preparer penalties that now apply to estate tax return preparers.

INTRODUCTION

The federal government imposes a filing requirement for all estates when the gross estate exceeds the exemption equivalent ($2 million in 2008; $3.5 million in 2009). In some cases, the estate tax return filing requirement, based solely on the size of the estate, can impose unnecessary and costly burdens benefiting neither the estate nor the government [1] [2]. In other cases, even when there is no filing requirement, planners find benefits in filing the estate tax return. An important feature of the estate tax return is the establishment of a record of the date of death values of the decedent's assets which will form the recipients' tax basis of these assets for income tax purposes [Internal Revenue Code (IRC) § 1014(a)(1). This rule will be effective until 2010 when the *Economic Growth and Tax Relief Reconciliation Act of 2001* [4] provides new carryover basis rules, with some exceptions, subject to change depending on what Congress does about the longer term future of the wealth transfer taxes.

A major reason given by lawyers for not filing the federal estate tax return is to avoid the cost of preparing the return, which can be several thousand dollars. This is one area where communication between CPAs and lawyers might be fruitful. It appears that lawyers are only looking at one side of the use of this information; the preparation of the federal estate tax return, which they have concluded has little value in these circumstances. However, much of the accumulation of information, especially the step-up in tax basis of decedents' assets, has to be done anyway in order to properly prepare the income tax returns of surviving spouses' and, or, other heirs. Additionally, while some information might not be needed immediately for income tax return purposes, it appears that gathering this information shortly after the death of decedent would be easier than digging through old records at some distant future date. This is efficient use of professional time avoids multiple startups and reduced sharpness and clarity in the haze of passing time.

This filing requirement appears to be an issue of lasting importance because, while what happens to the estate tax after 2010 is still being debated [7], there is nearly unanimous agreement among law makers that there will be no repeal of the estate tax [6]. Indeed, many wealthy individuals have indicated they

do not agree with the complete elimination of the estate tax. However, many of these are leaving the bulk of their estates to charity [10].

While most of these comments view this as a wholly financial decision, recent legislation and post-Enron ethics cast a different light. Under the *Small Business and Work Opportunity Act of 2007* [9], preparer penalties apply to estate tax return preparers. Under this revision, penalties apply when any understatement is due to any position for which there is not a realistic possibility of its being sustained on its merits. Exceptions apply when the position is properly disclosed in the return.

THE UNLIMITED MARITAL DEDUCTION

In 1981, Congress passed the *Economic Recovery Tax* Act *of 1981* [5], thereby, eliminating all gift and inheritance taxes for transfers between spouses [IRC § 2056]. Prior to that time, the marital deduction was limited to $250,000, or if greater, 50 percent of the adjusted gross estate [IRC § 2056(c) as in effect before 1981]. The unlimited marital deduction meant that, when the first spouse died, and all assets were bequeathed to the surviving spouse, there would not be an estate tax liability (at the first spouse's death). This would also be the case if the only assets not going to the surviving spouse went to charity.

The Bypass Trust

The typical bypass trust makes use of the decedent's lifetime exclusion, passing this amount to children and other heirs without being taxed in the surviving spouse's estate. This can be accomplished even in cases where the surviving spouses received the income from this bypass trust during the surviving spouse's life. The use of a bypass trust equal to the decedent spouse's lifetime exclusion passes property to non spousal heirs with no transfer tax at the death of either the first or second spouse.

The Charitable Deduction

All amounts bequeathed to qualified charities also avoid estate taxes. As opposed to the limited deduction for charitable gifts for individual's income tax purposes, there is no limit to the charitable deduction that can be taken on a federal estate tax return.[5] In fact, large charitable deductions given during lifetime do not require that a gift tax return be filed and the amount reported to the Internal Revenue Service. This non requirement for filing a gift tax return supports the argument that large charitable contributions at death should not be cause for requiring the filing of a federal estate tax return.

The Tax Free Estate

Under current law, the amount of the decedent's estate that passes free of estate tax includes the lifetime exclusion amount, the unlimited marital deduction, and the unlimited charitable deduction. Therefore, it can be argued that when the term "the tax free estate" is used it should be this larger amount, not just the amount of the lifetime exclusion [IRC § 2055. Even very wealthy individuals can completely avoid estate taxes by giving all of their assets to qualified charities]. Because the current filing requirement is flexible and changes whenever the lifetime exclusion changes, some argue there was no intention of the part of Congress to insist on an estate tax return in cases where not tax is due. This supports the argument that Congress intended to require returns only when the transfers exceeded the tax free estate.

Penalties for Non Filing the Estate Tax Return

One other argument advanced as a reason that the Government does not want a return filed, unless there is a tax owed, has been interpreted from the potential penalties surrounding the preparation and filing of the return. First, and primarily referred to, by those arguing that no return is due unless it exceeds the tax

free estate (as broadly defined) is that the penalty for not filing, or for a delinquent return, is a percentage based on the tax due. Ergo, if there is no possibility of a tax due, there is no penalty for not filing which can be interpreted as the Government does not really want the tax return in these cases. However, there is another section of the Internal Revenue Code (IRC) that specifically speaks to penalties for failure to file required forms that do not have any taxes due, such as partnership returns, Forms 1099, etc.

At the same time, other penalties that apply to gross understatement of asset value or omission of assets when filing the return would not seem to apply in these situations because, again, there is no taxes due and, therefore, no penalties due. Indeed, one argument for not filing the return is the avoidance of potential penalties for having signed a fraudulent or grossly inaccurate return. It seems unlikely that this could happen merely by bad happenstance, because the IRS instructions and several treatises of preparing the federal estate tax return encourage the filing of incomplete returns, when necessary because some information is not currently available, when the return is due, rather than having the return become delinquent.

The *Small Business and Work Opportunity Tax Act of 2007* [9] substituted "tax return preparer" for "income tax return preparer" each place it appears in Sec. 6694, thereby extending the penalty to preparers of estate tax returns. The penalty was also raised to the larger of $1,000 or 50 percent of the fee that is earned from the preparation of the return. Could recommending that an estate not file be citable? Current practitioner penalties generally should not apply.

Professionals should also consult Treasury Department Circular 230--*Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service* [3].

CONCLUSION

Can it be ethical for the tax professional to not comply? Do professional ethics rules apply? Generally, when there is an applicable statute, there is no ethical dilemma. This paper is a first step in research intended to address the reporting requirement.

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