VALUING ASSETS FOR FORM 706:
PUTTING THE "GROSS" IN GROSS ESTATE

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EDUCATION

Wheaton College (Ill.), B.A. - 1975 (summa cum laude)
Harvard Law School, J.D. - 1978 (cum laude) (Board of Editors, Harvard Journal on Legislation; Note Editor; Harvard Journal on Law and Public Policy)

PROFESSIONAL BACKGROUND

Oppenheimer, Blend, Harrison & Tate, Inc., 1982 to present
U.S. Army, Judge Advocate General's Corp., 1978 to 1982

PROFESSIONAL ACTIVITIES

Fellow, American College of Trust and Estate Counsel
American Bar Association
Section of Real Property, Probate and Trust Law, American Bar Association
Section of Law Practice Management, American Bar Association
Section of Taxation, American Bar Association
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Board Certified Estate Planning and Probate Law - Texas Board of Legal Specialization
San Antonio Bar Association
San Antonio Estate Planners Council
Christian Legal Society
Board member, Baptist Health System Foundation
Board member, Nonprofit Resource Center of Texas, Inc.

LAW RELATED PUBLICATIONS AND ACTIVITIES

- Author and Speaker, ACTEC Annual Meeting, *Using Technology to Draft Estate Tax Returns*, March 1999.
- Author, *Am I Liable? Responsibilities and Liabilities of Texas Nonprofit Organization Directors*, 1999.
- Speaker and Author at University of Houston Law Foundation Business and Estate Planning, *Drafting Estate and Gift Tax Returns*, May 1998.
- Author and Speaker at Texas Bankers Association Trust Financial Services Division, *The Texas Probate Code and The Administration of Estates in Texas with 1997 Legislative Update*, October 1997.
- Speaker and Author at University of Houston Law Foundation Wills and Probate Institute, *Drafting Estate and Gift Tax Returns,* July 1997.
- Speaker and Author at State Bar of Texas 14th Annual Advanced Tax Law Course, *Current Developments in Estate, Gift and Generation Skipping Taxes,* September 1996.
- Speaker at University of Houston Law Foundation Wills and Probate Institute, *The Anatomy of a Will,* June 1996.
- Speaker at Docket Call in Probate Court, *The Anatomy of a Will*, March 1996.

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I. Valuation.

A. The gross estate in general. IRC Section 2031(a) states

> "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

Thus "value" is "value at time of death."

It is the regulations that expand upon the concept of value.

> "The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value...The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Treas. Reg. $20.2031-1(b).

B. Date of valuation. All property included in the gross estate is valued on the date of death (DOD). If alternate valuation is elected, the value as of date of death is still reported. Other than cash in a bank account, the value of an asset may not immediately be obvious and valuation of the assets is an important aspect of preparing the return.

C. Alternate valuation.

1. When election permitted. Alternate valuation may be elected only if the election will decrease both the value of the gross estate and the total net estate and GST taxes due after all allowable credits. IRC Section 2032(c).

2. How elected. Alternate valuation is elected by checking the appropriate box. The election may be made on a late filed Form 706 provided it is not filed more than one year after the due date including extensions. Once made, the election is irrevocable.

3. Property covered. If the election is made it must be made as to all property included in the gross estate on the date of death.

4. Applicable valuation dates. The property under alternate valuation is valued on the alternate valuation date (AVD) as follows:

a. Any property distributed, sold, exchanged, or otherwise disposed of or separated or passed from the gross estate by any method within six months after the decedent's death is valued on the date of distribution, sale, exchange, or other disposition, whichever occurs first.

b. Any property not distributed, sold, exchanged, or otherwise disposed of within the 6-month period is valued on the date 6 months after the date of the decedent's death.

c. Any property, interest, or estate that is "affected by mere lapse of time," is valued as of the date of decedent's death or on the date of its distribution, sale, exchange, or other disposition, whichever occurs first. The date of death value may be changed to account for any change in value that is not due to a mere lapse of time on the date of its distribution, sale, exchange, or other disposition. Instructions. p. 3.

Application of these rules to specific types of assets are discussed with the discussion of the schedules on which those assets are reported.

C. Valuation and basis. Under IRC Section 1014(a) the income tax basis of property acquired from or passing from a decedent is its fair market value at the date of death or at the alternate valuation date. This is often referred to as "stepped-up basis," because the value and the basis at death is usually more than the decedent's basis. Yet, there will be "stepped-down basis" where the decedent's basis is greater than the item's value on the date of death or alternate valuation date.

1. Spouse's community property. This change in basis rule also applies to the surviving spouse's undivided one-half community property interest when the decedent's one-half undivided interest is included in the decedent's estate. IRC Section 1014(b)(6).

2. Income in respect of a decedent. There is no change in basis for income in respect of a decedent.

a. What is income in respect of a decedent? Income in respect of a decedent (IRD) items are items of income earned by a decedent before death but paid to decedent's estate or heirs after death. IRD items are included both in the decedent's gross estate for estate tax purposes and in the estate's income or heirs' income for federal income tax purposes.

b. Double taxation. IRD items are subject to two taxes: estate tax and income tax. An IRD income tax deduction, equal to the amount of estate tax attributable to the IRD received by the estate or heir, IRC Section 691(c)(1), alleviates the double tax. The deduction is an itemized deduction that is not subject to the 2% floor on miscellaneous deductions. IRC Section 691(c)(2).

c. Examples of income in respect of a decedent. These are examples of some typical IRD items:

(1) Accounts receiveable of a cash-basis individual.

(2) Renewal commissions of insurance agents.

(3) Stock options. IRD may arise upon post-death exercise.

(4) Payments on installment options. Unpaid installments on an installment sales contract for property sold by the decedent are IRD. For the application of the rule to community property, see *Holt v. U.S.*, Ct. of Fed. C1., No. 96-356T, 11/10/97. If the installment payments received by the decedent would have been capital gain, then the IRD is also capital gain.

(5) Deferred compensation. This includes the last salary check, bonuses earned before death but paid after death, and deferred compensation paid under a formal agreement.

(6) Royalties. Accrued royalties under a patent license and minerals extracted before the date of death but paid after the date of death are IRD.

(7) Partnership income. The decedent's share of partnership income earned prior to the date of decedent's death is IRD.

(8) Interest. Accrued, unpaid interest is IRD as is the interest on U.S. savings bonds.

(9) Pensions and IRAs. Account balances for pensions and IRAs are IRD.

d. Separate reporting. The income in respect of a decedent component of any item of property should be separately listed, because the IRD component does not enter into determining basis and the separate reporting facilitates preparation of the estate's and heirs' income tax return. The preparer should consider separate listings for tax free income and capital gains.

e. Expenses in respect of a decedent. Just as there is income in respect of a decedent, there can also be expenses in respect of a decedent which should be deductible on the estate tax return as well as the income tax return.

f. Additional information. Additional discussion of income in respect of a decedent, may be found in Basi and Gladden, "Handling Income and Expenses of the Decedent's Last Year," *Estate Planning*, Nov. Dec. 1992, 356.

3. Nontaxable estates. Because of the increase in basis that may occur, there is an incentive to overvalue property in a non-taxable estate, but IRC Section 6662, discussed above, may impose additional tax where an underpayment of tax is attributable to an overvaluation statement.

4. Losses lost at death. For investments with a value less than basis, it is preferable for the taxpayer to take the loss before death because the stepped-down basis will result in no loss after death.

5. Property acquired from trans- feree. No stepped-up basis is available where property with a fair market value in excess of its adjusted basis is acquired by the decedent by gift within one year of death and such property passes from the decedent to the donor of such property. In such a case, the basis is the adjusted basis of such property in the hands of the decedent immediately prior to death. This rule also applies if the item of property is sold by the estate and the proceeds pass to the donor.

6. No return required. When no Form 706 is filed, a transferee is unable to use it to establish basis. In Texas, the inventory filed with the court should be the best method to establish basis when no Form 706 is filed.

D. Valuation discounts. In valuing assets valuation discounts may be appropriate for closely held business interests and fractional interests in real estate.

1. Lack of marketability discounts for real estate fractional interests. Fractional interests in real estate, including community property interests, may qualify for a discount from the pro rata value of the whole for lack of marketability

a. Costs of partition. The IRS has attempted to limit the factional interest discount to the costs of a partition suit. See *Fawcett Est. v. Comm.*, 64 T.C. 889 (1975), acq., 1978-2 C.B.2. The IRS obtained an opinion from a lawfirm in Seguin that the costs of a partition suit were no more than the greater of $5,000 or 15%. The IRS issued TAM 9336002 in May 1993, in which it stated that the maximum discount allowed in a situation involving undivided interests will be based on the cost of partition. The tax court has rejected the sole reliance upon the cost of partition in *LeFrak v. Comm.*, TC Memo 1993 - 526, *Cervin v. Comm.*, TC Memo 1994-550, and *Barge v. Comm.*, TC Memo 1997-188.

b. Discount well-established. A discount for lack of marketability for a fractional interest is well-established. In *Propstra v. Comm.*, 82-2 USTC ¶ 13, 475 (9th Cir.), the court held that the value of a decedent's undivided one-half interest in real estate held as community property was properly discounted by 15% to reflect the relative unmarketability of an undivided fractional interest in real property. The appeals court rejected the IRS' argument that the discount should be allowed only if the estate proved that it was likely that the decedent's community property interest would be sold apart from the other undivided one-half interest in the property.

c. Proof required. The estate must offer proof that the discount is appropriate and cannot rely on discounts in prior court cases. See *Estate of Pudim*, 44 TCM 1425, where the value of a decedent's undivided one-half interest in certain properties was determined on the basis of the decedent's proportionate interest in the properties. The estate did not offer any proof that the decedent's interest in the properties was not readily divisible and marketable, so its contention that a discount was appropriate was not sustained.

Estate of Berg, 61 TCM 2949 (1991), dealt with a minority interest in stock of a closely held real estate investment company, but what the court said regarding minority discount valuations is applicable to fractional shares in real estate.

> "Second, the valuation of the appropriate discounts must take into account all relevant facts and circumstances of the particular corporation at issue... This and other courts have decided many cases involving discounts. The fact that petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant. Therefore, in deciding the appropriate discounts in the instant case we will take into account all relevant facts and circumstances of petitioner's interest in Vaberg [the closely held corporation], and do not consider the amount of discount applied in other cases cited by petitioner as persuasive." *Id*. At 2953, *reversed on other grounds* 976 F2d 1163 (8th Cir. 1992).

d. Discount cuts both ways. The discount for a fractional interest is a two-edged sword. If a fractional interest is used to fund a pecuniary marital deduction or charitable deduction gift, then the discount will increase the fractional interest required to fully fund the gift. For example, a $500,000 pecuniary marital deduction gift will require more than 50% of a $1 million ranch.

2. Lack of marketability generally. A lack of marketability discount may be available for any asset for which there is no established market in which to sell the asset.

a. A lack of marketability discount may be available for almost any closely held business interest because there is no established market for such interests as there is for publicly traded securities.

3. Lack of control or minority discount. This discount is available for closely held business interests which do not carry the right to control business decisions.

a. Family attribution. Family attribution, or interests held by other family members of the transferor, are not to be considered in determining the transferor's percentage ownership for purposes of lack of control or minority interests. See Rev. Rul. 93-12, 1993-1 C.B. 202.

b. Transfers in contemplation of death. While transfers in contemplation of death are generally not included in the decedent's estate, in *Estate of Murphy,* 60 T.C.M. 645 (1990) transfers shortly before death were disregarded and the decedent's interest was valued as if she retained a majority interest. *Estate of Bright v. U.S.,*658 F.2d 999 (5th Cir. 1981), was distinguished.

4. Discount for capital gains tax. A discount should be allowed for the potential capital gains tax that would be due if the entity was liquidated. Until recently, the IRS and the courts did not recognize such a discount. However, the courts now recognize that a discount for capital gains tax liability upon liquidation may be appropriate when valuing an interest in a corporation. See *Estate of Davis v. Commissioner*, 111 T.C. 35 (1998). Prior to *Davis,* no discount for built-in gain in valuing stock was allowable. The IRS did not recognize such a discount and the courts concurred because (1) such a discount was speculative, and (2) prior to the 1986 Tax Reform Act and the repeal of the *General Utilities* doctrine, such discount was not needed because a company could liquidate all of its assets without incurring any capital gains tax.

In *Davis,* the court allowed a taxpayer to discount the value of closely held stock for gift tax purposes for built-in capital gains. The court determined that a willing buyer and a willing seller would take into consideration that the assets of a company were subject to potential capital gains tax in valuing the stock. The court agreed with the taxpayer that the discounts should be allowed, even though no liquidation was contemplated, because there was no practical way to avoid the taxes.

The Second Circuit relied on the *Davis* decision in determining that an adjustment for built-in capital gains tax should be considered when valuing the stock in a closely held corporation. See *Irene Eisenberg v. Commissioner* [No. 97-4331, 1998 U.S. App. LEXIS 20109 (August 18, 1998)]. The Second Circuit did not give consideration to when the taxpayer will sell or distribute the property or liquidate the company. In fact, the court reached its decision even though no sale or distribution of the property, or liquidation of the corporation, was planned at the time of the gift. As in *Davis,* the Second Circuit considered whether a hypothetical willing buyer would consider the potential built-in capital gain in determining the fair market value of the stock. The court ultimately determined that such buyer would give full consideration to the affect of the built-in capital gain in valuing the stock.

5. Key-man discount. The loss of a key person provides reason to discount the value of a business interest. This discount is recognized by the IRS for stock in a closely held business. Rev. Rul. 59-60, 1959-1 C.B. 237.

6. Additional information. "Strategies for Obtaining the Largest Valuation Discounts," *Estate Planning,* Jan. Feb, 1994, 38.

E. Estate value not conclusive for basis. In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS ruled that the value for estate tax purposes is not conclusive but is a presumptive value that may be rebutted by clear and convincing evidence, except where the taxpayer is estopped by the taxpayer's previous actions or statements.

F. Basis of special assets. For a discussion of basis of business interests and the assets in those business interests and of life estates and remainder interests, see Stewart, Randall, and Gardner, "Property Acquired From a Decedent: Establishing Basis," *Estate Planning,* Nov. Dec. 1993, 355.

II. Schedule A - Real Estate.

A. When completed. Schedule A is completed when real estate is included in the estate, with these exceptions:

1. Jointly owned real estate. Any jointly owned real estate held by the decedent and one or more co-owners in joint tenancy, and by the decedent and spouse as joint tenants or tenants by the entirety are reported on Schedule E. "Joint" means with survivorship. Instructions, Schedule E, and Form, Schedule A, p. 4.

2. Real estate part of a sole proprietorship. Real estate that is part of a sole proprietorship owned by the decedent is reported on Schedule F. Instructions, Schedule F, and Form, Schedule A, p. 4.

3. Reversionary interests and remainders. These are properly reported on Schedule F.

4. Real estate included in gross estate not titled in decedent. Real estate included in the gross estate under Sections 2035, 2036, 2037, or 2038 are properly reported on Schedule G. Form, Schedule A, p.4.

5. Real estate subject to power of appointment. Any real estate subject to a power of appointment and included in the gross estate under Section 2041 is properly reported on Schedule H. Form, Schedule A, p. 4.

6. Leaseholds. Leaseholds are pro- perly reported on Schedule F. Form p. 20.

7. Real estate decedent contracted to sell. Real estate that the decedent contracted to sell is properly listed on Schedule C. Form p. 14.

8. Real estate previously subject to marital deduction. Real estate that is Section 2044 property, property subject to a marital deduction in the estate of the decedent's previously deceased spouse or by lifetime gift to the decedent from the decedent's spouse, is properly reported on Schedule F.

9. Cooperative apartment. An interest in a cooperative apartment should be reported on Schedule B.

B. Non-probate property. It does not make any difference whether the real property passes by testamentary or non-testamentary transfer. The regulations provide, "Real property is included whether it came into the possession and control of the executor or administrator or passed directly to heirs or devisees." Treas. Reg. §20.2033-1(a).

C. Required information. The instructions for Schedule A state,

> "Describe the real estate in enough detail so that the IRS can easily locate it for inspection and valuation. For each parcel of real estate, report the area and, if the parcel is improved, describe the improvements. For city or town property, report the street and number, ward, subdivision, block and lot, etc. For rural property, report the township, range, landmarks, etc." Form, p. 5.

D. Valuation. The instructions and regulations do not require that an appraisal be submitted.

1. How determined. On value, the instructions simply state, "Explain how the reported values were determined and attach copies of any appraisals." Form, p. 5

2. Property tax value. Other than the general valuation rules, and a specific statement that "Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date," Treas. Reg. §20.2031-1(b), the regulations contain little guidance on valuing real property.

3. Appraisal. Even though not re- quired, an appraisal for significant real property in a taxable estate may be the better practice, to avoid valuation penalties and to obtain the lowest reasonable value for the property.

a. Review real estate appraisals. The preparer of the return should review every real estate appraisal for accuracy before entering the value on the schedule and marking the appraisal as an attachment to the return.

□ Are the legal description and the street address correct?

□ Is the description of the property correct, *i.e.*, is the floor plan or site plan correct, is the general description of the property correct?

□ Are the valuation methods properly stated or are the reasons for not using that valuation method adequately explained?

□ Are *comparable sales* used when there are sales near the valuation date of properties with reasonably similar characteristics?

□ Is *replacement cost* used to estimate what it would cost to rebuild the structures at current construction prices with appropriate reduction for depreciation?

□ Is *capitalization of income* used for valuing income producing property?

□ Are the comparables comparable, *i.e.* are they similar properties and are they in similar locale?

□ Is the zoning the same?

□ For a residence, is the school district the same?

□ Are square footages or acreage similar?

□ Substantial adjustments to comparables may indicate that they are not really comparable.

□ Are adjustments in comparables taken in the right direction?

□ Does the appraisal make appropriate adjustments in value for significant differences in financing?

□ Have changes in the economy been taken into account?

□ Are photographs of the right property and are they correctly labeled?

□ Are appropriate discounts taken for significant periods required to market the property?

□ Are appropriate discounts taken for discounts for fractional interests and are the discounts supported by market data?

□ Are adverse easements considered?

□ Are the appraisers exceptions, such as not considering defects in titles, considerations that need to be addressed for this particular property?

□ Does the appraisal state the correct valuation date (DOD or AVD)?

4. Sales value. If the real property is sold soon after the date of death, the sale price is probably the best indication of value. The value should be the gross sales price unreduced by the costs of sale. The costs of sale can be deducted as a reasonable expense of administration according to the IRS, only if the sale was necessary to raise funds to pay taxes, debts, or expenses of administration. Form p. 24.

In *Estate of Sirmans v. Comm.*, TC Memo 1997-241, the tax court did not accept a low value indicated by a sale of a strip of the land to the county, because the executor had incentives to sell for less than the land was worth.

5. Homestead rights. The value of the property is not to be reduced if it is subject to homestead rights. Form, p. 5. No reduction is to be made for dower, courtesy, or a statutory estate created instead of dower or courtesy.

6. Rents. Rents accrued through the date of death are included in the gross estate, Treas. Reg. §20.2033-1(b). Rents should be listed separately and they represent income in respect of a decedent.

E. Mortgages. Mortgaged real property should be reported one of two ways, depending upon the decedent's personal liability.

1. Personally liable. If the decedent was personally liable for the mortgage, or if the indebtedness may be charged against other property of the estate that is not subject to the mortgage, then the full value of the real property is reported on Schedule A, and the amount of the unpaid mortgage may be deducted on Schedule K. Form, p.5. Here the amount of the unpaid mortgage can exceed the value of the real property with a net decrease to the estate.

2. Non-recourse. If the decedent's estate is **not** liable for the amount of the mortgage, then report on Schedule A the value of the property less the unpaid indebtedness, but an amount not less than zero. Form, p. 5. In this situation, no indebtedness is listed on Schedule K.

F. Contracts to purchase. Schedule A should list any real property that the decedent contracted to purchase. The full value of the property (which may not necessarily be the purchase price) is listed on Schedule A and the unpaid portion of the purchase price is listed on Schedule K. Form, p. 5.

G. Special rule for cemetery lots. Cemetery lots, some of the most expensive real estate when priced on a per square foot basis, may not need to be included in the gross estate. The regulations provide, "A cemetery lot owned by the decedent is part of his gross estate, but its value is limited to the salable value of that part of the lot which is not designed for the internment of the decedent and the members of the decedent's family." Treas. Reg. §20.2033-1(b). The regulations do not state who is considered a member of the decedent's family, and they may give the opportunity for a broad reading of that term.

H. Alternate valuation.

1. Rent. Rent accrued to the date of the decedent's death on leased real property is included in the alternate valuation. Rent accrued after the date of death is not included. Instruction p. 3.

2. Mineral proceeds. The DOD value includes minerals extracted before the date of death and paid after decedent's death. Minerals extracted after decedent' death through the AVD are included in the AVD value. Seldom, if ever, will producing minerals be valued less on AVD than on DOD. The gross estate of a decedent whose executor elected to value the estate on the alternate valuation date included the proceeds from the sale of oil and gas under the decedent's royalty interests during the six-month period after the decedent's death because the proceeds represented a change in the form of the estate's assets at the time of the decedent's death rather than income. *Johnston v. Comm.*, 779 F.2d 1123 (5th Cir.1986).

3. Appraisals. If alternate valuation is elected, the appraiser should update the appraisal to the AVD.

I. Attachments.

1. Copies of any appraisals should be attached. Instructions p. 5.

2. If value is based upon ad valorem tax appraisal, attach the tax statement to the return.

3. If value is based upon sale, attach closing statement.

J. On audit. The examining agent on audit is told to request copies of all appraisals made on the real estate within five years of death, copies of all listings on the property with the Realtor's' names within three years of death, and a copy of the closing statement if the property was purchased within five years of death. Examiner's Handbook, Section 630(4).

III. Schedule A-1 — Section 2032A Valuation.

A. Special use value. IRC Section 2032A provides for election of special use value on certain real property used in a farm or business. A detailed analysis of the detailed requirements of special use value are beyond the scope of this article.

B. Generally. If the requirements of IRC Section 2032A are satisfied, property may be valued at its actual use. Real property used for farming or held by closely held business may be valued on the basis of its value as a farm or use in the closely held business rather than its highest or best use value. Section 2032A may not be used to reduce the decedent's gross estate by more than $750,000 and may not be used unless the adjusted fair market value of the real and personal property is 50% or more of the adjusted value of the gross estate.

1. Adjusted for inflation. The $750,000 maximum exclusion in the value of farm property having a fair market value greater than its agricultural use value, will be subject to cost-of-living adjustments beginning in 1999, under The Taxpayer Relief Act of 1997.

C. Substantial compliance.

1. Before Taxpayer Relief Act. If special use value was to be claimed on the return, there must be substantial compliance with the requirements.

Estate of Hudgins v. Commissioner, 57 F.3rd 1393, 95-2 USTC ¶ 60,202 (5th Cir. 1995), involved a Texas ranch and a $150,000 deficiency.

The case gives an extensive analysis of IRC Section 2032A, the section's legislative history, and cases dealing with the "substantial compliance" issue. The Court of Appeals reversed the Tax Court and held that an estate could not correct its defective election where the Notice of Election contained only 9 of the 14 items required by the instructions and the regulations and the notice and the recapture agreement were signed by only three of the five qualified heirs. A memorandum attached to the return explained that one of the heirs had not signed because he was in the military service and the other had not signed because he was not presently available. The memorandum stated "to remedy that situation, the undersigned preparer of this Form 706 will undertake to obtain the signatures." No steps were undertaken to remedy the defects until the Service notified the estate that the election was defective. The Court concluded that these deficiencies precluded the estate from qualifying for the 90 day relief provision.

In *Estate of Kokernot v. Comm.*, 79 AFTR 2d 97-2739 (5th Cir. 1997), the appeals court held that the tax court properly determined that the estate waived its ability to elect IRC §2032A special use valuation for the decedent's cattle ranch, despite the protective election made on the original estate tax return, because the issue was not raised in the estate's petition to the tax court or during negotiation of the tion of ranstipulated settlement that established the ranch's value. The estate argued that the 60 day period for perfecting the election began on entry of the settlement agreement, but the appeals court held that under Treas. Reg. §20.2032A-8(b) the final determination of the ranch's value was rendered by IRS's deficiency notice.

2. After Taxpayer Relief Act. By changes made under the Taxpayer Relief Act of 1997, with respect to decedents dying after the date of enactment, the IRS must notify the personal representative if the notice of election for special use valuation does not contain all necessary information or if all required signatures have not been obtained. The personal representative will then have a reasonable time to cure the omissions.

IV. Schedule B - Stocks and Bonds

A. When completed. According to the instructions, Schedule B must be completed and filed when the gross estate contains any stocks or bonds. Instructions, p. 8. Actually, the gross estate may include stocks or bonds that are not reported on Schedule B.

1. Jointly held. Jointly held stocks and bonds are properly reported on Schedule E.

2. Lifetime transfers. Stocks and bonds transferred by the decedent yet included in the gross estate under one of the lifetime transfer provisions are properly reported on Schedule G.

3. Subject to power of appointment. Stocks and bonds subject to a power of appointment are properly reported on Schedule H.

4. Subject to marital deduction. Stocks and bonds that are Section 2044 property, property subject to a marital deduction in the estate of the decedent's previously deceased spouse or by lifetime gift to the decedent from the decedent's spouse, are properly reported on Schedule F.

B. Stocks.

1. Required information. For stocks, the Instructions, p. 9, require the following information:

a. Number of shares
b. Whether common or preferred
c. Issue
d. Par value where needed for identification
e. Price per share
f. Exact name of corporation
g. Principal exchange upon which sold, if listed on an exchange
h. CUSIP number, if available
i. Principal business office, if stock is unlisted

2. Dividends. Dividends are to be separately listed on each stock. Instructions, p. 9.

a. Decedent stockholder of re- cord. Dividends not collected at death, but payable to the decedent or the estate because the decedent was a stockholder of record on the date of death should be listed. Instructions, p. 9.

b. Ex-dividend. For a stock being traded on an exchange and selling ex-dividend on the date of death, do not include the amount of the dividend as a separate item. Add the amount of the dividend to the ex-dividend quotation in determining the fair market value of the stock on the date of the decedent's death. Instructions, p. 9; Treas. Reg. §20.2031-2(i).

c. Decedent not stockholder of record. Dividends declared on shares of stock before the death of the decedent but payable to stockholders of record on a date after the decedent's death are not includible in the gross estate. Instructions, p. 9.

d. Community property. Generally, for a married decedent, dividends from stocks, even separately owned stocks, will be community property and an undivided one-half community property interest included in the estate. Watch for dividends that should be reported on the separate property stocks of decedent's surviving spouse.

e. Income in respect of a decedent. Dividends are an income in respect of a decedent item, which is also subject to income tax.

f. Alternate valuation. Dividends declared to shareholders of record on or before the date of the decedent's death are considered property of the gross estate on the date of death, and are included in the alternate valuation. Ordinary dividends payable to shareholders of record after the date of death are generally not included in the gross estate if alternate valuation is elected. Dividends declared to stockholders of record after the date of death such that the shares of stock at the later valuation date do not reasonably represent the same property at the date of death, are included in the alternate valuation unless they are dividends paid from earnings of the corporation after the date of the decedent's death.

3. Valuing restricted securities. Recently, the courts decided what this author describes as a "metaphysical case." A stock transfer restriction that disappeared on the date of death could still be used to reduce the value of the stock for estate tax purposes.

In *Estate of McClatchy v. Commissioner*, 147 F.3d 1089 (1998), the Ninth Circuit held that unregistered securities restricted under Rule 144 of the Securities Act of 1933 should be valued at their lower, restricted price. In reversing the Tax Court, the Ninth Circuit noted that, in *McClatchy*, death alone did not bring about the transformation in the value of the stock. The estate, as the beneficiary of the stock, was not an affiliate of the company and therefore could sell the stock without the restriction. The court reasoned that, had the estate been an affiliate, then the restrictions on sale of the stock would have continued to apply. As pointed out in the dissent, with the court's decision, restricted securities can now be taxed at a value below that at which the securities can actually be sold.

C. Bonds.

1. Required information. For bonds, the Instructions, p. 9, require the following information:

a. Quantity and denomination
b. Name of obligor
c. Date of maturity
d. Interest rate
e. Interest due date
f. Principal exchange, if listed on an exchange
g. CUSIP number, if available
h. The principal business office, if bond is unlisted.

2. Interest.

a. List interest rate and amount on each bond separately.

b. Generally, for a married decedent, interest from bonds, even separately owned bonds, will be community property and an undivided one-half community property interest included in the estate. Watch for interest that should be reported on the separate property bonds of decedent's surviving spouse.

c. Interest is an income in respect of a decedent item.

3. Alternate valuation. Interest accrued after the date of death is not included in the gross estate when alternate valuation is elected. Interest accrued before the date of death is included in the alternate valuation.

4. Exempt bonds. Bonds that are exempt from Federal income tax are not exempt from estate tax unless specifically exempted by an estate tax provision of the IRC. Public housing bonds must be included at their full value. Instructions, p. 8.

D. Stocks and bonds subjected to foreign death taxes. If the estate paid any estate, inheritance, legacy, or succession tax to a foreign country on any stocks or bonds properly listed on Schedule B, those stocks and bonds are to be grouped together and labeled "Subjected to Foreign Death Taxes." Instructions, p. 8.

E. Valuation.

1. In general. The regulations state that the value of stocks and bonds is the fair market value per share or bond on the applicable valuation date. Treas. Reg. §20.2031-2(a).

There are basically three kinds of stock: i) publicly traded stock; (ii) a substantial block of publicly traded stock, and (iii) closely held stock.

2. Sales on valuation date.

a. According to the instructions and the regulations, the fair market value of a stock or bond, listed or unlisted, is the mean between the highest and lowest selling prices quoted on the valuation date. Instructions, p. 9, Treas. Reg. §20.2031-2(b)(1).

b. For bonds, if only closing prices are available, then the fair market value is the mean between the quoted closing selling price on the valuation date and on the trading day before the valuation date. Instructions, p. 9. Treas. Reg. §20.2031-2(b)(2).

3. No sales on valuation date. Where there are no sales on the valuation date, the Instructions, p. 9, give two alternate methods for determining the value. These methods are used where the valuation date falls on a weekend or a holiday.

a. Selling prices exist. Where there are sales and high and low selling prices:

(1) "Find the mean between the highest and lowest selling prices on the nearest trading date before and the nearest trading date after the valuation date. Both trading dates must be reasonably close to the valuation date.

(2) "Prorate the difference between the mean prices to the valuation date.

(3) "Add or subtract (whichever applies) the prorated part of the difference to or from the mean price figured for the nearest trading date before the valuation date." Instructions, p. 9.

The regulations state that a weighted average is to be used, the average to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. Treas. Reg. §20.2031-2(b)(1).

b. Bid and ask. The instructions and regulations provide that where there are no actual sales made reasonably close to the valuation date, the same computation as above should be made using the mean between the bona fide bid and asked prices instead of sales prices. Instructions p. 9; Treas. Reg. §20.2031-2(c).

c. Incomplete prices available. If actual sales prices or bona fide bid and asked prices are available within a reasonable period of time before the valuation date but after the valuation date, or vice versa, then the mean between the highest and lowest sales prices or bid and asked prices is used as the value. Instructions, p. 9.

d. When fair market value not reflected. If the selling or bid and asked prices do not accurately reflect fair market value, then modifications or consideration of other factors are to be made to reflect fair market value. Treas. Reg. §20.2031-2(e).

(1) Selling prices unavailable. The regulations state that few or sporadic sales at or near the valuation date may not indicate fair market value. *Id.*

(2) Blockage discount. A blockage discount may be appropriate where the block of stock is large compared to actual sales and the offering on such a block may depress the market. Data in support of the discount needs to be submitted with the return. *Id.* See *Estate of Foote*, TC Memo 1999-37, where a blockage discount for publicly traded stock of 22.5% is denied and the court limited the discount to 3.3%.

(3) Controlling interest. The IRS also places a premium on a controlling interest. "[I]f the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value." *Id.*

e. Securities on multiple exchanges. The Instructions, p. 9, and regulations, Treas. Reg. §20.2031-2(b)(1), provide that if a security was listed on more than one stock exchange, the records of the exchange where the security is principally traded or the composite listing of combined exchanges (if available) in a publication of general circulation should be used.

f. Brokers quotations. When obtaining quotes from brokers, use caution, because for publicly traded stocks and bonds, they usually give the closing sale price on the valuation date or the last trading date before the valuation date, which only partially meets the required information for calculating value. The instructions and regulations request that copies of quotations from brokers, or evidence of the sale of securities from the officers of the issuing companies should be attached to the return. Instructions, p. 11; Treas. Reg. §20.2031-2(b)(1).

g. Valuation services. The most cost effective way to obtain values is to use a valuation service that provides the information by fax, modem, or internet. Usually the only information required is the valuation date, the number of shares or face amount of bonds and the CUSIP number. See Appendix A, "Valuation Software," for names and addresses of several valuation services.

4. Stock in closely held corporations. The value of stock in closely held corporations is one of the greatest areas of uncertainty, requiring the skills of qualified appraisers to obtain the lowest defensible values when dealing with a taxable estate.

a. The Instructions, p. 9, are quite brief and do not hint of the valuation difficulties:

> "Apply the rules in the section 2031 regulations to determine the value of inactive stock and stock in close corporations. Send with the schedule complete financial and other data used to determine value, including balance sheets (particularly the one nearest to the valuation date) and statements of the net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date."

b. IRC Section 2031(b), makes specific reference to the valuation of unlisted stock:

> "Valuation of Unlisted Stock and Securities--In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."

(1) Selling prices unavailable. The regulations are more expansive on what is required where selling prices or bid and ask prices are unavailable.

(a) For bonds. The soundness of the security, the interest yield, the date of maturity, and "other relevant factors" are to be considered. Treas. Reg. §20.2031-2(f)(1). The instructions state that bonds, such as municipal bonds, that are exempt from federal income tax are not exempt from federal estate tax unless the bond is specifically exempted by an estate tax provision of the code. Instructions, p. 8.

(b) For stocks. The company's net worth, prospective earning power and dividend--paying capacity, and "other relevant factors" are to be considered. Treas. Reg. §20.2031-2(f)(2).

(c) Other relevant factors. "The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange," are all "factors to be considered." Treas. Reg. §20.2031-2(f). The weight to be given to any one factor will depend upon the facts of each case, according to the regulations.

(d) Nonoperating assets. To the extent nonoperating assets have not been taken into account in the determination of net worth, prospective earning capacity and dividend-earning capacity, they should be considered. Treas. Reg. §20.2031-2(f). See discussion as this applies to life insurance at VI. C.

(e) Required information. The regulations state that complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports made by accountants, engineers, or technical experts. Treas. Reg. §20.2031-2(f).

(2) Valued at moment of death. *Estate of Charles McClatchy v. Commissioner*, 106 TC 206 (1996) held that shares of stock were to be valued without regard to Rule 144 restrictions which applied during the decedent's lifetime but became inapplicable at decedent's death. The value without the restrictions was held to be the value at the moment of death. This an important case on timing for estates where death affects the value of estate assets.

(3) Fractional interest discounts. Gifts of closely held corporate stock on six valuation dates were involved in *Mandelbaum v. Commissioner*, T.C. Memo 1995-255. This is a gift tax case, but nevertheless, an important valuation case applicable to estates. The opinion of the Service's expert was rejected because it gave insufficient weight to the family's intent to keep the company privately held and the restrictions employed to achieve this purpose. The donors' expert opinion was rejected because he gave too much weight to the rights of first refusal in the shareholder agreements. The court did its own analysis based on various factors that are discussed extensively in the opinion. The court ruled that a 30% marketability discount allowed by the Service's expert should be applied. This case was affirmed on appeal for the reasons set forth in the Tax Court opinion, *Mandelbaum v. Commissioner*, 78 AFTR 2d 96-5159 (3rd Cir. 1996).

Twenty-five percent lack of marketability discount and ten percent minority discount were allowed in *Wheeler v. United States*, 77 AFTR 2d 96-1405 (W.D. Tex. 1996) 77 AFTR 2d 96-1411, where the decedent owned 50% of the stock in a closely held corporation and his two sons owned the remaining 50%. The Service agreed that the estate was entitled to a 25% discount for lack of marketability but contended that no discount for minority interests was appropriate because the decedent's interest was not a minority interest. The court granted an additional 10% discount noting that the reason for granting a minority discount, namely lack of control, also applies in a case of a 50% ownership interest. The taxpayer submitted an appraisal report reflecting a 10% discount for a minority interest and the government offered no contrary evidence.

The Tax Court rejected the Service's valuation of a partnership interest in *Estate of Barudin v. Comm.*, TC Memo 1996-396. Decedent owned a one-ninety-fifth interest in a general partnership that owned two commercial office buildings. Decedent died at the end of 1989, a year that saw the major building tenant inform the partnership of its intent to leave in five years and the start of a recession in commercial real estate. At trial, the estate argued for a value of $200,000 and the court rejected the Service's expert's valuation of the partnership assets, for failure to account for the recession and failure to make adjustments for date of sale, location, condition, or size of the property. The court also rejected the Service's 15% discount because it did not sufficiently account for the control by another partner. But, the court also rejected the estate's combined 67.5% discount, instead concluding that a 19% minority interest discount and a 26% lack of marketability discount, for a total of 45% were appropriate.

In LTR 9550002, a block of closely held stock owned outright by the decedent was aggregated with the stock held in a QTIP trust includible in the decedent's gross estate under Section 2044 and treated as one block of stock for valuation purposes.

> "Property for which a marital deduction was allowed under section 2056(b)(7) in the estate of the first spouse to die, is treated, for purposes of the estate and gift tax upon the death of the surviving spouse, as if it passed to the remainder beneficiaries from the surviving spouse. See section 2044(c). Thus, for purposes of the estate tax, the property is treated as if it had been owned outright by the surviving spouse and passed from the spouse to those ultimately receiving the property."

A similar conclusion was reach in LTR 9608001 (2/23/96) where a limited partnership interest held in the decedent's revocable trust and includible in the decedent's gross estate under section 2038 was aggregated with limited partnership interests that were created after the predeceased spouse's death. The Service took the position that the purpose of the QTIP statute is to treat the QTIP property as if it were the spouse's own property.

The Fifth Circuit has disagreed with the aggregation theory in *Bonner v. United States,* 77 AFTR 2d, ¶ 96-868 (5th Cir. 1996). Husband died owning undivided fractional interests in real estate and a boat. A QTIP trust created under his predeceased wife's will owned the remaining interests. A QTIP election was made in the wife's estate. The husband's estate included the QTIP interest in his taxable estate under IRC Section 2044. In valuing the husband's taxable estate, his estate applied fractional interest discounts to the real estate and the boat. The IRS determined the deficiency on the theory that the QTIP trust's interests and the husband's interests merged at death extinguishing the fractional interests and resulting in a 100% ownership by the husband's estate. The district court agreed with the IRS and the Fifth Circuit sided with the estate. The Fifth Circuit opinion explained that the inclusion of the trust's interests under IRC Section 2044 does not also mean that as a matter of property or trust law, the QTIP trust's separate interests merged with those of the husband's estate.

Estate tax valuation, the Court ruled, should reflect the reality that, at the death of Bonner, the hypothetical willing seller, for Section 2031 purposes, valuation cannot be presumed able to negotiate free of the trust's separate interests. The court stated,

> "The question before us is controlled by the holding in *Bright [v. United States,* 658 F.2d 999 (5th Cir. 1981) (en banc)]. Although Section 2044 contemplates that the QTIP property will be treated as having passed from Bonner for estate tax purposes, the statute does not require, nor logically contemplate that in so passing, the QTIP assets will merge with other assets. The assets in the QTIP trust could have been left to any recipient of Mrs. Bonner's choosing, and neither Bonner nor the estate had any control over their ultimate disposition."

The court went on to say that this holding was supported by public policy.

> "The estate of each decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions. In this case, Mrs. Bonner controlled the disposition of her assets, first into a trust with a life interest for Bonner and later to the objects of her largesse. The assets, although taxed as if they passed through Bonner's estate, in fact were controlled at every step by Mrs. Bonner, which a tax valuation with a fractional interest discount would reflect. At the time of Bonner's death, his estate did not have control over Mrs. Bonner's interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of the handicaps associated with fractional undivided interests. The valuation of the assets should reflect that reality."

(4) Appraisal. When a taxable estate includes stocks or bonds in an unlisted corporation, an appraisal may be worth the expense, both in terms of obtaining the lowest defensible value and a value that is defensible.

(a) Review before filing. The estate tax return preparer should thoroughly review the appraisal before submitting it with the return, to make sure the information is accurate and the conclusions sound. In the event of an audit, the return preparer usually will be the primary person to defend the appraisal.

(5) Securities with no value. The Instructions, p. 10, provide that securities reported as of no value, nominal value, or obsolete should be listed last, with the address of the company and the state and date of incorporation with copies of correspondence or statements used to determine the value. Before decedent's death, securities with no value but a basis greater than zero should be sold in order to create a capital loss. In addition to a step-up in basis on death there is a step-down when the value is less than basis before death.

E. Stock Options. The instructions do not state the proper schedule on which to report nor the required information for stock options, either qualified or non-qualified. Presumably, they may be reported on Schedule B or on Schedule F.

A stock option is an opportunity given an employee by the employer-corporation to purchase stock of the employer-corporation in the future at a predetermined price.

For a discussion of the estate tax aspects of stock options, including basis and income in respect of a decedent, see, Cohen and Falanga "How to Handle Stock Options Held at the Employee's Death," *Estate Planning*, Mar. Apr. 1992, 96.

F. Flower bonds. Whatever happened to flower bonds? We no long need to concern ourselves with the estate tax aspects of flower bonds because the last bonds matured November 15, 1998. If you have a decedent dying before that date who held such bonds, see Rev. Rul. 69-489, 1969-2 C.B. 172 for the special valuation rules, and see Rev. Proc. 69-18, 1969-2 C.B. 300 for redemption to pay estate tax.

G. Attachments. The following documents should be included as attachments:

1. Copies of quotations from brokers. Instructions, p. 9.

2. Copies of valuations of publicly traded securities.

3. Data in support of blockage discounts. Treas. Reg. § 20.2031-3(e).

4. Evidence of the sale of securities from the officers of the issuing companies should be attached. Instructions, p. 9.

5. Copies of any appraisals of closely held businesses.

6. For closely held stocks, include "complete financial and other data used to determine value, including balance sheets (particularly the one nearest the valuation date) and statements of net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date." Instructions, p. 9.

7. Copies of correspondence as statements used to determine that securities are of no value. Instructions, p. 9.

H. On audit. On audit the examining agent is told to ask for any sales or offerings of closely-held stock. Examiner's Handbook, Section 7(11)1(2). For closely held corporations, the agent is to inspect the corporation's federal income tax returns for the last five years for (1) changes in officers, (2) changes in stockholdings, and (3) changes in time devoted to the corporation. *Id.* Section 7(11)3(1).

V. Schedule C - Mortgages, Notes, and Cash

A. When completed. Schedule C is completed and filed with the return if the gross estate includes any mortgages, notes or cash. Form, p. 14. Actually, the gross estate may include mortgages, notes or cash that are not reported on Schedule C.

1. Jointly held. Jointly held mortgages, notes and cash are properly reported on Schedule E.

2. Lifetime transfers. Mortgages, notes and cash transferred by the decedent yet included in the gross estate under one of the lifetime transfer provisions are properly reported on Schedule G. This would appear to require listing on Schedule G cash held in a trust account at a financial institution.

3. Subject to power of appointment. Mortgages, notes and cash subject to a power of appointment are properly reported on Schedule H.

4. Subject to marital deduction. Cash that is Section 2044 property, property subject to a marital deduction in the estate of the decedent's previously deceased spouse or by lifetime gift to the decedent from the decedent's spouse, are properly reported on Schedule F.

B. How reported. Items reported on Schedule C are to be grouped in categories and listed in the following order:

a. Mortgages
b. Promissory notes
c. Contracts by the decedent to sell land
d. Cash in possession
e. Cash in banks, savings and loan associations and other types of financial institutions.

C. Mortgages and promissory notes.

1. Payable to decedent. Mortgages and notes payable to the decedent are listed on Schedule

C, and mortgages and notes the decedent owes are listed on Schedule K.

2. Required information. For mortgages and promissory notes, the instructions state "List: face value; unpaid balance; date of mortgage; date of maturity; name of maker; property mortgaged; interest dates; and interest rate." Form, p. 14.

3. Valuation. Mortgages and notes may raise interesting valuation issues.

> "The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation." Treas. Reg. §20.2031-4.

a. Collection treated as income. The problem with valuing a note less than its face amount or outstanding balance is that any amount collected that exceeds the value reported on the Form 706 will be taxed as ordinary income.

b. **Self-cancelling notes.** *Estate of Musgrove v. U.S.*, 33 Fed. Cl. 657;95-2 U.S.T.C. ¶ 60,204 (Fed. Claims 1995) involved the amount of a loan advanced by the decedent one month before decedent's death at age 84. Decedent's son signed an interest-free, unsecured, demand promissory note and received $251,540 from decedent. The note, by its terms, was to be canceled upon decedent's death. The note was reported on the decedent's estate tax return as part of the gross estate. Then the executor claimed that the amount of the transfer should not be included in the decedent's gross estate. The court held for the IRS finding that the facts of the case demonstrated that the transfer was an intra-family gratuitous loan that lacked full and adequate consideration. There is a presumption that an intra-family transfer is a gift that may be rebutted by an affirmative showing that there existed a real expectation of repayment and intent to enforce the collection of the indebtedness. The existence of a promissory note, drafted by an attorney, does not change the presumption when there is an implied agreement among family members that the grantor will not make a demand on the obligation and that the note was not intended to be enforced.

4. Accrued interest. Accrued and unpaid interest is to be separately listed, see regulation above, and included in the gross estate. It represents income in respect of a decedent.

5. Alternate valuation date. Gen- erally, the interest will be the same on the date of death and for alternate valuation. The note will also generally be the same, unless there is a change in the factors that go into valuing the note, such as a change in interest rates, change in the value of the security, or a change in the financial position of the maker.

D. Contracts by the decedent to sell land. According to the instructions, such contracts are properly listed on Schedule C and not Schedule A. The instructions state, "list: name of purchaser; contract date; property description; sale price; initial payment; amounts of installment payment; unpaid balance of principal; and interest rate." Form, p. 14.

1. Valuation. A bona-fide contract entered into in an arm's length transaction will generally be valued at the contract price, unless a discount is appropriate due to the terms of the contract, such as a long installment term, a low interest rate, or low value of the underlying property that will be securing the sale. A contract that is not bona-fide or not entered at arm's length will be disregarded and the underlying property will be valued.

2. Income in respect of a decedent. Income from a contract to sale property that is binding on the date of death is IRD. The value of the contract is not to be reduced for income taxes on the installments. *Estate of Robinson v. Commissioner*, 69 T.C. 222 (1977). In *Estate of Robinson*, the court found the reduction for possible income taxes to be inconsistent with the willing buyer-willing seller test of Treas. Reg. § 20.2031-1(b).

E. Cash in possession.

1. Cash on hand. The instructions require that cash on hand be listed separately from bank deposits. Form, p. 14. The regulations state, "The amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another ... is included in the decedent's gross estate." Cash on hand would include cash normally carried on the person, cash in home safes, and cash kept in safe deposit boxes.

2. Numismatic value. Cash on hand is normally reported at its face value, but cash worth more than its face value must be reported at its higher value, preferably on Schedule F. Rev. Rul. 78-360, 1978-2 CB 228.

F. Cash in banks and other financial institutions. The instructions require that bank accounts be listed separately from other cash. Form, p. 14.

1. Uncleared checks. The regulations provide, "If bank checks outstanding at the time of the decedent's death and given in discharge of bona fide legal obligations of the decedent incurred for an adequate and full consideration in money or money's worth are subsequently honored by the bank and charged to the decedent's account, the balance remaining in the account may be returned, but only if the obligations are not claimed as deductions from the gross estate." Treas. Reg. §20.2031-5.

This permits the listing on the return of the "check register amount" rather than the bank balance with the need to determine which checks cleared after the date of death and should be listed on Schedule K.

In PLR 9735003 the IRS ruled that checks written to a family limited partnership prior to the decedent's death that had not cleared the decedent's bank by the date of death were includible in the decedent's gross estate as cash on hand. The IRS concluded that the funds given to the partnership did not represent the satisfaction of a bona fide legal obligation of the decedent.

2. Outstanding gift checks.

a. Charitable gifts. A gift by check to a charity is complete on delivery if the check subsequently is honored by the bank. Such a check can be deducted from the bank balance reported on Schedule C. *Estate of Belcher v. Commissioner,* 83 T.C. 227 (1984).

b. Non-charitable gifts. A donor of a non-charitable gift may revoke a gift by check (by stopping payment on the check) until it is honored by the bank. Such a gift must be honored by the bank before death to be considered a completed gift and excluded from the decedent's estate. Rev. Rul. 67-396, 1967-2 C.B. 351; *Estate of Joseph Gagliardi v. Commissioner*, 89 T.C. 1207 (1987). The same conclusion was reached by the Tax Court in *Estate of Newman*, 111 T.C. 81 (1998), where Decedent's son had written $95,000 of checks under a durable power of attorney shortly before her death.

3. Required information. The instructions state, "List: the name and address of each financial organization; the amount in each account; serial or account number; and nature of account--checking, savings, time deposit, etc.; and unpaid interest accrued from date of last interest payment to the date of death." The instructions also state, "If you obtain statements from the financial organizations, keep them for IRS inspection." Form, p. 14.

4. Accrued, unpaid interest. Neither the regulations nor the instructions require it, but accrued unpaid interest as of the date of death should be separately listed and included in the gross estate. Accrued, unpaid interest is income in respect of a decedent.

5. Alternate valuation. Cash in banks will have the same value on the date of death as it will have on the alternate valuation date.

6. Penalties for early withdrawal. Certificates of deposit and other term savings are properly valued at face amount plus accrued unpaid interest through the date of death without any reduction for penalties for early withdrawal. Under federal regulations governing banks, such certificates can be redeemed prior to maturity upon the death of the owner. Rev. Rul. 79-340, 1979-2 CB 320.

G. Foreign currency. Foreign currency and bank deposits can either be listed on Schedule C or Schedule F. No specific requirements are contained in the instructions or the regulations. The alternate valuation date value can be different than the date of death value due to fluctuations in exchange rates.

H. Attachments. The following should be attachments to the return:

1. Any appraisal of a note reported at less than its remaining balance.

2. The author finds it good practice to attach a copy of any note reported at less than its remaining balance.

3. Copies of bank statements should not be attached, but due diligence would indicate that these be received and reviewed by the preparer.

I. On audit. On audit the examining agent is told to request all cancelled checks, bank statements, check registers, savings passbooks, and ledgers for three years before the death. Examiner's Handbook, Section 821 (1). If there are unusual withdrawals, a request is to be made of where it went and for what purpose. *Id.* Section 823. Cash in the decedent's safe deposit box is to be presumed to be the decedent's. *Id* Section 830(3). Prior income tax returns are to be examined for unreported notes and mortgages. *Id.* Section 841. Discounting of a demand note for lack of a current adequate interest rate is to be disallowed. *Id.* Section 842(1). If an unsecured note is reported as worthless, the estate should show that it has taken all possible legal action to collect, that collection action would be useless, or that the debtor cannot be located. *Id.* Section 842(2). Notes in the decedent's possession should not be conceded as forgiven before death unless notations of payment exist or gift tax returns were filed. *Id.* Section 843(1).

1. Preparer review. Because items may be requested upon audit, the preparer should request and review these items as part of preparing the return.

VI. Schedule D - Insurance on the Decedent

A. Reporting life insurance. You must report on Schedule D any life insurance on the decedent's life, whether or not included in the gross estate, unless included in the gross estate under a section other than IRC Section 2042. Form, p. 16. For each policy, list the name of the insurance company and the policy number.

1. What is insurance? "The term 'insurance' refers to life insurance of every description, including death benefits paid by fraternal beneficiary societies operating under the lodge system, and death benefits paid under no-fault automobile insurance policies if the no-fault insurer was unconditionally bound to pay the benefit in the event of the insured's death." Form, p. 16.

2. Form 712. For every policy listed on Schedule D, you must request a Form 712, Life Insurance Statement, from the life insurance company that issued the policy, and attach the Form 712 to the return. Form, p. 16.

a. If Form 712 not available. It may be impossible to get a Form 712 on some types of insurance. For example, the Veterans Administration does not issue a Form 712 for a policy sold to veterans. If a Form 712 is not available, usually a copy of the check or check stub for the proceeds will suffice.

b. Application also attached. If the Form 712 shows someone other than the insured as the owner, a copy of the application is to be attached to the Form 712 by the insurance company.

3. Value reported. The instructions require that the net proceeds received, line 24 of Form 712, be entered on Schedule D if paid in one sum. If paid in more than one sum, then the value of the proceeds as of the date of death, line 25 of Form 712, are listed. Form, p. 16.

a. Post-mortem dividends, post mortem interest. The total proceeds should include payments properly determined to be post-mortem dividends, which are dividends payable after death with respect to periods before death when the policy was in effect, less policy loans. But the gross estate should not include any interest paid for any period after death because payment of proceeds was delayed. Sometimes insurance companies improperly term interest as post-mortem dividends.

b. Post-death interest. Post-death interest is not included in the gross estate, but should be reported as income by the beneficiary of the proceeds.

c. Unearned premiums. Unearned or refunded premiums are included in the gross estate.

4. Alternate valuation. For proceeds received as a lump sum, the same amount is listed for DOD and AVD values.

a. If payable as a life annuity or installments over a fixed period of years, the amount used by the insurance company to determine the annuity or installments will probably be the AVD value.

b. If an annuitant dies during the period between the DOD and the AVD, the value of the annuity should be the same as the value of an annuity under similar facts for Schedule I.

B. Insurance included in the gross estate.

1. When included. Under IRC Section 2042, the gross estate includes:

(i) Insurance on the decedent's life receivable by or for the benefit of the estate; and
(ii) Insurance on the decedent's life receivable by beneficiaries other than the estate, if the decedent held any of the incidents of ownership.

2. In favor of the estate. Schedule D should include the full amount of proceeds receivable by the executor or otherwise payable to or for the benefit of the estate.

> "Insurance in favor of the estate includes insurance used to pay the estate tax, and any other taxes, debts, or charges that are enforceable against the estate. The manner in which the policy is drawn is immaterial as long as there is an obligation, legally binding on the beneficiary [of the insurance proceeds], to use the proceeds to pay taxes, debts, or charges. You must include the full amount even though the premiums or other consideration may have been paid by a person other than the decedent." Form, p. 16.

a. Community property. Under this instruction, if all the proceeds are paid to the decedent's estate, the entire proceeds are in the gross estate, even if the policy was community property and the decedent's surviving spouse owned an undivided one-half community property interest. As discussed below, that is not the rule [see D(1) below].

b. Differing tax results. A different tax result can occur depending upon whether the proceeds are paid to the ultimate recipient directly or are paid to that recipient under the terms of a will or by intestacy after the proceeds are first paid to the estate. Consider two situations where the proceeds end up in a testamentary trust that does not qualify for the marital deduction.

(1) If the proceeds are payable directly to the trust and the decedent held no incidents of ownership, then the proceeds will not be included in the gross estate and will avoid being subject to estate taxes, or

(2) If the proceeds are paid to the probate estate and the will passes the proceeds, either as a specific devise, a general bequest or a residuary bequest, to the testamentary trust, then the proceeds will be subject to estate taxes.

c. When payable to the estate. Proceeds will be payable to the estate:

(1) Where the estate is designated as the primary beneficiary.

(2) The estate is designated as the secondary beneficiary or contingent beneficiary and the primary beneficiary is not paid.

(3) Where no beneficiary is named or the beneficiaries named do not survive to receive the proceeds and the proceeds are payable to the estate under the terms of the policy. This may be the case where the decedent had a life insurance policy from a credit card membership and death occurred on a common carrier when the ticket was purchased on the credit card.

(4) Where no beneficiary is named or the beneficiaries named do not survive to receive the proceeds and the proceeds are payable to the estate by operation of law.

Check the policy and the beneficiary designation to confirm that the Form 712 lists the proper beneficiary.

3. Decedent held incidents of ownership. The gross estate includes all life insurance on decedent's life if the decedent possessed at death any of the "incidents of ownership," exercisable alone or in conjunction with any person. Form, p. 16.

a. "Incidents of ownership"

defined. Incidents of ownership, according to Treas. Reg. §20.2042-1(c)(2) and p. 16 of the Form, include:

(1) The right of the insured or estate to its economic benefits.

(2) The power to change the beneficiary.

(3) The power to surrender or cancel the policy.

(4) The power to assign the policy or to revoke an assignment.

(5) The power to pledge the policy for a loan.

(6) The power to obtain from the insurer a loan against the surrender value of the policy.

(7) A reversionary interest if the value of the reversionary interest was more than 5% of the value of the policy immediately before the decedent died. "(An interest in an insurance policy is considered a reversionary interest if, for example, the proceeds become payable to the insured's estate or payable as the insured directs if the beneficiary dies before the insured.)" Form, p. 16.

(i) The decedent does not have a reversionary interest if some other person held the power to obtain the cash surrender value immediately before the decedent's death. Treas. Reg. §20.2042-1(c)(3).

(ii) Nor does a reversionary interest include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person. *Id.*

(8) An insured has an "incident of ownership" in an insurance policy held in trust if the decedent, either alone or in conjunction with another person, has the power as trustee or otherwise to change the beneficial ownership in the policy or its proceeds. Treas. Reg. §20.2042-1(c)(4).

State law will determine whether a decedent held such incidents of ownership.

b. Fiduciary held powers. A fiduciary power does not require, *per se*, that the policy be included in the estate of the fiduciary insured, if the power cannot be used to benefit the fiduciary insured. Rev. Rul. 84-179, 1984-2 C.B. 195.

C. Policies held by a corporation.

1. Proceeds paid to the corporation. If a corporation holds incidents of ownership and the proceeds are payable to the corporation; then the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership. Treas. Reg. §20.2042(c)(6). The proceeds will be included in valuing the corporation and the decedent's stock in the corporation. Treas. Reg. §20.2031-2(f).

2. Proceeds not paid to the corporation. If any part of the proceeds of the policy are not payable to or for the benefit of the corporation any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through the decedent's stock ownership where the decedent is the sole or controlling shareholder. To be a controlling shareholder, the decedent must possess more than 50 percent of the total combined voting power of the corporation. *Id.*

3. Exclusions.

> "Not taxable in the insured's gross estate under § 2042 are key man insurance, insurance for the funding of stock redemptions, buy-sell agreements, § 303 redemptions, salary continuation and deferred compensation plans and credit life insurance, since these coverages are all for the benefit of the corporation. However, they may be considered in the valuation of the majority stockholder's stock, depending on how the latter is valued." F. Berall, *Preparing the 706*, (National Law Foundation, 1998) 6-73.

D. Community property policies.

1. If a policy was community property, then the non-insured, surviving spouse's community property interest is not included in the insured's estate. Treas. Reg. §20.2042-1(b)(2).

a. This is the case even if the entire proceeds are payable to the decedent's estate.

b. This is the case even if the policy was sole management community property and the decedent alone could change the beneficiary. Treas. Reg. §20.2042-1(c)(5).

2. The *Cavenaugh* case is an interesting application of this rule where the non-insured spouse predeceased the insured.

In *Estate of Cavenaugh v. Commissioner*, 51 F.3d 597, 95-1 USTC ¶60,195 (5th Cir. 1995), the Court of Appeals addressed the predeceasing non-insured spouse's interest in a community property life insurance policy. In 1980, husband and wife used community funds to purchase $600,000 guaranteed renewable and convertible term policy on husband's life. Wife died in 1983, then husband died in 1986. The policy proceeds were paid to husband's estate as the named beneficiary. In filing the estate tax return, husband's estate excluded one-half of the insurance proceeds from the gross estate.

The Tax Court found that because a term policy provides pure life insurance and has no cash surrender value or loan value but merely furnishes insurance protection for a specified period of time, any community interest wife may have had lapsed on the policy's first renewable date following her death. The community interest of predeceasing uninsured spouse ordinarily is settled by distributing one half of the policy's cash surrender value of the spouse's estate, according to the Tax Court. Because the policy had no cash surrender value, wife's community interest in the policy was zero and no distribution was necessary to settle her community interest.

The Court of Appeals rejected the Tax Court's analysis and concluded that the Tax Court "conflates 'value' with a "property interest." "Within and without Texas, property is distinct from value; surely one can own property that is worthless by any market measure, but still not subject to confiscation by the state or invasion by other members of the public. Although a term policy has no cash value, it, nevertheless, is a property interest. In Texas, the status of property is fixed at the time of acquisition or inception of title. Since the term life insurance policy was acquired with community property, the first spouse to die would own and pass in such spouse's estate a one-half interest in the policy and its proceeds. Where settlement of the deceased spouse's community interest in a policy was not made prior to the death of the insured, the deceased spouse's community interest was never extinct and the policy retained its community status as a tenancy in common up until the time of maturity."

The dissent addressed two troublesome issues in the case. Proceeds were paid to the insured's estate and IRC Section 2042(1) could require inclusion. Also, the wife's one-half interest in the policy was held in trust for the husband and for which QTIP election was made.

3. In *Estate of Cervin v. Comm.*, 111 F.3rd 1252 (5th Cir. 1997) the non-insured spouse died first and the tax court included 100% of proceeds of life insurance policies purchased with community funds in the insured spouse's estate. The appeals court held that the insured spouse's estate included only one-half of the proceeds from life insurance policies and awarded the decedent's estate litigation costs.

E. Simultaneous death.

1. Community property. For a discussion of the community property aspects of life insurance where there is simultaneous death of husband and wife, see, Clary and Anderson, "Anticipating the possibility of simultaneous deaths in light of Uniform Acts presumptions," *Estate Planning*, Sept. Oct. 1987, 280.

2. Valuation. In the event of the simultaneous death of the owner and the insured, valuation is at the replacement or interpolated terminal reserve value plus the unearned premium. Rev. Rul. 77-181, 1977-1 C.B. 272; *Chown v. Comm.*, 428 F.2d 1395, 70-2 U.S.T.C. ¶ 12, 702 (9th Cir. 1970).

F. Insurance otherwise not included.

1. Insurance not included in the gross estate according to the rules of IRC Section 2042, cited above, may still be included under IRC Sections 2035, 2036, 2037, and 2038. This includes insurance on the decedent's life transferred by the decedent during his life and includible in his gross estate under one or more of the lifetime transfer provisions:

(a) Transfers within three years of death, Section 2035. This includes the proceeds of policies assigned by the insured within three years of death and included as a Section 2035 transfer.

(b) Transfers with retained life estate, Section 2036.

(c) Transfers taking effect at death, Section 2037.

(d) Revocable transfers, Section 2038.

2. Such insurance is properly reported on Schedule G.

G. Insurance on life of another. Insurance on the life of a person other than the decedent is reported on Schedule F.

H. Irrevocable life insurance trusts.

1. How listed? How is life insurance on the life of the decedent owned by an irrevocable life insurance trust to be listed?

Some believe the policies should be listed on Schedule G along with the trust itself. It is clear that trusts of which the decedent is the grantor are to be listed on Schedule G. The argument goes, if the trust is to be listed on Schedule G, then the policies owned by the trust should also be listed there.

Others believe that the policies should be listed on Schedule D while the trust is listed on Schedule G. The general rule is that insurance on the decedent's life is listed on Schedule D, unless the insurance is included in the estate under Sections 2035, 2036, 2037, or 2038. But, policies owned by an irrevocable trust are not included in the estate, so they are not in the exceptions to the general rule. The policy would be listed on Schedule D., but the value is listed as zero.

2. Purchase within three years. If the policy was acquired within three years of death and the insured held no incidents of ownership (eg. the policy was acquired by the trustee directly from the insurance company), and the proceeds are not payable to the insured's estate or executor, then the proceeds are not to be included in the insured's estate. *Estate of Leder v. Commissioner,* 89 T.C. 235 (1987), *aff'd.* 893 F.2d 237 (10th Cir. 1989). This applies even if the insured paid the premiums. *Estate of Frank Perry v. Commissioner,* 91-1 U.S.T.C. ¶ 60,064 (5th Cir. 1991). The preparer may still be reasonable in not including in the estate proceeds paid under a policy that was intended to not be included, even though the insured may have technically held an incident of ownership.

I. On audit. The examining agent is instructed to inspect a copy of the original application or assignment to prove the decedent's lack of ownership. Examiner's Handbook Section 911(3). The agent is to look for credit life insurance on the decedent, by looking at obligations on Schedule K. *Id*. Section 950(2)(d). Bank accounts are to be examined for premium payments. *Id.* Section 950 (2)(e).

VII. Schedule E - Jointly Owned Property

A. When completed. "Jointly Owned Property" is limited to joint tenants with rights of survivorship and tenants by the entirety. If the decedent had an interest, then the property must be reported on Schedule E, whether or not the interest is included in the estate, Form, p. 18, and regardless of whether the property is real or personal. The instructions state that Schedule E must be completed if a "yes" answer is given to Part 4, Question 9, "Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which (a) one or more of the other joint tenants was someone other than the decedent's spouse, and (b) less than the full value of the property is included on the return as part of the gross estate?" Instructions p. 5.

1. Jointly owned property. "Jointly owned property" does not include property held as tenants in common or community property. Partnership interests are listed on Schedule E only if the interest itself is jointly owned. Form, p. 18.

2. Community property. It is possible to have community property that is jointly owned. Community property that is jointly owned should be clearly identified as community property. Jointly owned separate property gets a step-up in basis only on the decedent's interest while community property gets a step-up in basis in both spouse's interests.

3. How determined. To determine whether an account at a financial institution is jointly owned, you must look at the signature card or account agreement that established the account. You cannot rely on the name printed on checks or the addressee of account statements. For real property, you must review the deed. The preparer should request that the personal representative provide copies of all signature cards, account agreements, and deeds for review.

B. Qualified joint interests.

1. "Qualified joint interest" defined. A "qualified joint interest" is a joint interest held by the decedent and the decedent's surviving spouse, if the interest is held as:

a. Tenants by the entirety (not available under Texas law); or

b. Joint tenants with rights of survivorship if the decedent and the decedent's spouse are the only joint tenants.

c. If the surviving spouse is not a U.S. citizen, then the joint interest is not a qualified joint interest and it should be reported on Part 2 of Schedule E. Form, p. 18.

2. Where reported. Qualified joint interests are reported on Part 1 and all other joint interests are reported on Part 2. Forms, p. 18. One-half of a qualified joint interest is included in the decedent's estate, and the interest will qualify for the marital deduction.

C. Joint interests. For joint interests that are not qualified joint interests and are listed on Part 2, the presumption is that the full value of the jointly owned property is included in the estate. Form, p. 18.

1. When full value not included. The full value is not included in the gross estate if:

a. It can be shown that a part of the property originally belonged to another tenant and was never received or acquired by the other tenant or tenants from the decedent for less than adequate and full consideration in money or money's worth; or

b. It can be shown that any part of the property was acquired with consideration originally belonging to the surviving joint tenants.

2. Amount excluded. An amount proportionate to the consideration furnished by the other tenant or tenants is excluded from the value of the property.

3. Gifted property. Under these rules, if the decedent gave another person a sum of money or other property which thereafter became the other person's entire contribution to the purchase price of jointly owned property, then the entire value of the property is included in the decedent's gross estate, regardless of the fact that the gifted property may have appreciated in value due to market conditions between the time of the gift and the time of the acquisition of the jointly owned property. Treas. Reg. §20.2040-1(c)(4). The length of time between the gift and the purchase does not affect this result.

4. Income from gifted property. If the decedent transfers to another person for less than an adequate and full consideration in money or money's worth income producing property, the income from which becomes the donee's entire contribution to the purchase of jointly owned property, then the value included in the decedent's gross estate is the entire value of the jointly owned property less the portion attributable to the income which the donee furnished. Treas. Reg. §20.2040-1(c)(5).

5. Jointly owned property received by gift. The instructions provide:

> "If the property was acquired by the decedent and another person or persons by gift, bequest, devise, or inheritance as joint tenants, and their interests are not otherwise specified by law, include only that part of the value of the property that is figured by dividing the full value of the property by the number of joint tenants." Form, p. 18.

6. Proof required. If less than full value is included in the estate, then proof of the extent, origin, and nature of the decedent's interest and the interests of the decedent's co-tenant or co-tenants must be attached to the return. Form, p.18.

D. How reported? The property is to be described as required in the instructions for Schedules A, B, C and F for the type of property involved. Form, p. 18.

E. Disclaimer of the joint interests. Previously the IRS took the view that a disclaimer of a joint interest was not qualified if the disclaimer was more than nine months after the joint interest was created.

1. Proposed regulations. The IRS position was not sustained in the courts, and it has finalized proposed regulations, Treas. Regs. § 25.2518-1 and § 25.2518-2 to bring the disclaimer regulations into line with the holdings of the courts.

2. Disclaimer regulations for joint interests. In general, the regulations provide that for a joint tenancy that may be unilaterally severed by either party or a tenancy by the entirety, the surviving joint tenant may disclaim the survivorship interest within nine months of the death of the first joint tenant to die. The surviving joint tenant can't disclaim any portion of the account attributable to the survivor's own contributions.

3. Disclaimer and basis. There may be a planning opportunity under the regulations for an increased step-up in basis if there is a disclaimer of non-community joint property. If the decedent had $1,000,000 held in a joint brokerage account with his spouse, and if the surviving spouse disclaims $500,000 from the joint account, that $500,000 becomes probate property and receives an increased basis. Of the remaining $500,000, one-half also receives a step-up in basis. Instead of a step-up in basis of only $500,000, there is a total step-up of $750,000. *See* Comments of Beverly R. Budin, Estate and Gift Tax Section Meeting, Tax Section, ABA, January 10, 1997.

F. On audit. Because joint property is not included in the probate estate, the examining agent is to ask the executor what inquiry he made of the family about joint property. Examiners' Handbook, Section (10)20(2). The agent is to be suspicious when family members are left out of the will and they do not contest. *Id*. Also, the agent is to see if the executor's failure to rebut the "presumption of inclusion" is an effort to get a higher basis for the surviving joint tenant. *Id.* Section (10) 32(4).

VIII. Schedule F--Other Miscellaneous Property.

A. When completed. Schedule F is to be completed, (at least the three questions posed on the schedule), and filed with the return whether or not property is listed on the schedule.

1. Articles of value. The first question, to be answered "Yes" or "No": "Did the decedent at the time of death own any articles of artistic or collectible value in excess of $3,000 or any collections whose artistic or collectible value combined at date of death exceeded $10,000? If "Yes," submit full details on this schedule and attach appraisals."

a. The instructions with the form misread the question by calling for a "yes" answer if there is just one article with artistic or intrinsic value regardless of the value:

> "If the decedent owned at the date of death articles with artistic or intrinsic value (e.g., jewelry, furs, silverware, books, statuary, vases, oriental rugs, coin or stamp collections), check the "Yes" box on line 1 and provide full details. If any one article is valued at more than $3,000, or any collection of similar articles is valued at more than $10,000, attach an appraisal ..."

b. If you answer "yes" to the question, the instructions require "an appraisal by an expert under oath and the required statement regarding the appraiser's qualifications (see Regulations Section 20.2031-6(b)." Form, p. 20. This statement, according to the regulations, is to be made by the executor!

> "The appraisal shall be accompanied by a written statement of the executor containing a declaration that it is made under the penalties of perjury as to the completeness of the itemized list of such property and as to the disinterested character and the qualifications of the appraiser or appraisers." Treas. Reg. §20.2031-6(b).

The author has never seen the IRS attempt to enforce the demands of this regulation.

c. The preparer of the return should carefully review any appraisal to make sure the appraisal complies with the requirements for appraisals and does not accept or state conditions that may cause value to be greater than or lesser than fair market value. Look at the following conditions taken from an actual fine art appraisal; the author's comments in brackets.

"The fair market value of the donated item is $465,950.00. Fair market value is defined as the estimated price agreed upon by a willing buyer and a willing seller, both knowledgeable of all relevant facts, neither being under any compulsion to buy or sell, and both given a reasonable amount of time to complete the transaction. The fair market value is determined by a sale in the most appropriate marketplace for the item."

[A correct statement of fair market value.]

"In this appraisal value has been established by the sales comparison approach. This method of valuation involves comparison of the property with similar items which have sold in the market I consider most common for items of this type, commercial art galleries and auction houses."

[Again, a substantially correct statement.]

"This appraisal is based on the readily apparent identity of the item and no further guarantee of authenticity, genuineness, attribution or authorship is made."

[If the item being appraised was not genuine, that would have a substantial effect upon fair market value. If the apparent authorship is not correctly attributed, then value is probably overstated. One of the typical expectations of an appraiser is to certify that an object is genuine.]

"The appraisal is the whole interest and possessory interest of the client, undiminished by any liens, fractional interests or any other form of encumbrance or alienation. However, this appraisal is not an indication or certificate of title of ownership. The identification of the interest of the client has been represented to me by my client and no inquiry or investigation will be made nor is any opinion to be given as to the truth of such representation."

[Something of this sort is present in almost all appraisals. If the decedent does not have a whole interest or if there are liens or encumbrances, that should be verified and revealed to the appraisers. An appraisal that addresses an existing partial interest will be more accurate and will probably decrease the appraised value.]

"The value conclusions expressed herein are based on the appraiser's best judgment and opinion and are not a representation or warranty that the items will realize those values if offered for sale at auction or otherwise. The values expressed are based on current information on the date the appraisal was made. No opinion is expressed as to past, present or future value."

[The appraisal may not be a warranty or guarantee that the value will be reached by sale, but it certainly is a representation. This is the whole point of the appraisal. The appraised value should be based on information current as of the valuation date (DOD or AVD), not the date of the appraisal. If no opinion is expressed as to value, post, present or future, then do not get an appraisal. An appraisal *is* an opinion as to value.]

The above appraisal makes no mention of the condition of the items being appraised. If comparables are for items in perfect, "mint," or top condition, then any negative conditions should be addressed in the appraisal, or an attempt made to use comparables for items in similar condition. For example, coins are appraised using sales of coins in comparable grades and stamps are appraised based upon comparable sales of stamps in the same condition. Less than the best condition can substantially decrease the value of estate property, the decrease depending upon the property being appraised.

2. Bonus. The second question, to be answered "Yes" or "No": "Has the decedent's estate, spouse, or any other person, received (or will receive) any bonus or award as a result of the decedent's employment or death? If "Yes," submit full details on this schedule."

a. This question may require a "yes" answer, even though the bonus or award is not included in the gross estate.

b. A bonus or award, paid after death by the decedent's employer is includible in the gross estate if (i) there was a legal liability on the part of the employer at decedent's death to pay the bonus, or (ii) before death, the decedent's right to receive the bonus or award was contingent but by reason of death the right to receive the payment became unconditional. *RIA's Complete Guide: Federal Estate Tax Return*, p. 110.

c. A bonus or award paid after death by the decedent's employer is *not* includible in the gross estate if, at the time of death, there was no legal obligation on the part of the employer to pay a bonus awarded after death. Rev. Rul. 65-217, 1965-2 CB 214.

3. Safe deposit box. The third question to be answered "Yes" or "No": "Did the decedent at the time of death have, or have access to, a safe deposit box? If "Yes," state location, and if held in joint names of decedent and another, state name and relationship of joint depositor. If any of the contents of the safe deposit box are omitted from the schedules in this return, explain fully why omitted."

d. It is not unusual to have property in a safe deposit box not included in the gross estate because of community property. A simple statement to that effect usually does not raise a problem.

e. If the safe deposit box in Texas is opened by the duly appointed personal representative (executor, administrator, or temporary administrator), the opening need not be done in front of a bank official and a detailed inventory is not required. If the box is opened by a family member prior to appointment of a personal representative to look for a burial plot deed or a will, the opening must be done in the presence of a bank official and a detailed inventory of the box contents must be prepared. Texas Probate Code §36D.

B. Checklist. *RIA's Complete Guide: Federal Estate Tax Return* [no longer in print], p. 112, gives this checklist of items to be listed on Schedule F.

Accounts receivable
Aircraft
Antiques
*Art objects
*Automobiles
Boats
Bonus claims
*Books
*Business interests (unincorporated)
Checks, unnegotiated
*Claims
Clothing
*Coin collections
Collections, miscellaneous
Commissions, claims to
Compensation, decedent's right to
Contingent claims
Contingent remainder, not extinguished
  by decedent's death
*[Contraband]
Co-partnership interest
Copyrights
Crops (growing at decedent's death)
[Currency collections]
[Currency, foreign]
*Debts due decedent (other than mortgages
  and notes), [loans]
Deferred compensation claims
Engravings
Escrow accounts
Estate, interest in
Estate income, accrued at decedent's death
Etchings
Farm products [and growing crops]
*Farm machinery (marital ded.) [sic]
Fees, uncollected
Fire insurance premiums prepaid for
  periods after death
Furnishings
Furniture
Furs
Gems
Goodwill
Horses, thoroughbred
*Household goods and effects
*Insurance (on life of person other than
  decedent)
[Interests in business]
Jewelry
Joint ventures
Judgments
Leaseholds not reportable as real estate
  in Schedule A
Life insurance (on life of persons other than
  decedent)
*Livestock
[Loans (other than mortgages and notes)]

[Lottery winnings]
*Marital deduction (Section 2044) property
Medical insurance reimbursement due decedent

at death
[Non-qualified pension plans]
*Oriental rugs
*Paintings
Partnership interest
Partnership profits, estate's share in
Patents
Personal effects
Personal property, tangible
Pets, pedigreed
Professional practices
Real estate owned by sole proprietorship
Receivables and refunds, miscellaneous
Remainder interest
Residuals
Reversionary interests
Rights
Royalties
Salary
Sculpture
Section 2044 property
Security deposits
Severance pay claims
*Silverware
Sole proprietorships
Stamp collection
Statuary
[Stock options]
*Tax refund claims
*Trust funds, shares in
Trust income accrued to decedent's death
Trust interests
Vases
Wages
Wearing apparel

Items marked by an asterisk (*) are discussed below. Bracketed items [ ]added to list by author of this article.

1. Art. The blockage discount, recognized in Treas. Reg. §20.2031-2(e) in connection with the valuation of a block of stock so large that it cannot be liquidated in a reasonable time without depressing the market, as also been applied to valuation of works of art. See *Estate of O'Keeffe*, TCM 1992-210 (the estate of painter Georgia O'Keeffe) and *Estate of Smith*, 57 TC 650 (1972) (estate of sculptor David Smith).

The ruling in TAM 9152005 that the value of art objects stolen during World War II and possessed by the thief at death was the price that would be paid by a willing buyer in a discreet retail market or the legitimate art market is questionable. Stolen art would generally not have access to the legitimate art market.

2. Automobiles. There is a significant difference between the amount a used automobile dealer would pay and the amount a consumer would pay the used automobile dealer. Notice that published lists usually have a sale and a dealer sale price. The regulations require that the value be "the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles." Treas. Reg. §20.2031-1(b).

The harsh effects of this valuation provision, requiring inclusion at a value greater than what the estate can receive upon sale, are ameliorated by Treas. Reg. 20.2053-3(d)(2), which permits deduction of expenses for selling property 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.

> "Where an item included in the gross estate is disposed of in a bona fide sale (including a redemption) to a dealer in such items at a price below its fair market value, for purposes of this paragraph there shall be treated as an expense for selling the item whichever of the following amounts is the lesser: (i) the amount by which the fair market value of the property on the applicable valuation date exceeds the proceeds of the sale, or (ii) the amount by which the fair market value of the property on the date of the sale exceeds the proceeds of the sale." Treas. Reg. § 20.2053-3(d)(2).

3. Books. When an appraisal is involved, the regulations provide "In the appraisal, books in sets by standard authors shall be listed in separate groups." Treas. Reg. §20.2031-6(d).

4. Business interests, unincorporated. The instructions require that for any interest in a partnership or unincorporated business, to attach a statement of assets and liabilities for the valuation date and for the five years before the valuation date, and statements of the net earnings for the same five years. Goodwill must be accounted for, and the same information should be furnished and the same methods followed as are provided for close corporations, listed on Schedule B. Form, p. 20.

a. Real estate owned by a sole proprietorship is reported on Schedule F and not Schedule A. Form, p. 20.

b. Items of property held for sale in the course of a business generally should be reflected in the value of the business. Treas. Reg. §20.2031-1(b).

5. Claims. According to the instruc- tions, these include the value of the decedent's interest in a claim for refund of income taxes or the amount of the refund actually received. Form, p. 20. See "Tax Refund Claims" below.

6. Coin collections. Because coins are also "cash," coin collections could also be properly listed on Schedule C.

7. Contraband. TAM 9207004 is one of those amazing rulings that state an IRS position that should not be accepted as the final word. A planeload of marijuana over which the decedent had exclusive possession and control at the time of death was valued at the retail street value of average grade marijuana in the area where the decedent had attempted to land his plane. It seems that a substantial discount should be available because of the risk in selling an illegal substance.

8. Crops. This includes both harvested and crops growing on the valuation date. The regulations require that they be itemized and the value of each be separately returned. Treas. Reg. §20.2031-1(b).

9. Debts due the decedent. Notes and mortgages are listed on Schedule C. Form, p. 20. Schedule F will include loans not represented by a signed instrument.

10. Estates, interest in. Because the interest in property is not owned directly, but rather indirectly through an estate, the value of the underlying assets may be entitled to a discount. Comments by Malcolm Moore, Philip E. Herkerling Institute on Estate Planning, Jan. 1999. See *Estate of Crossmore*, 56 TCM 483, where the decedent's interest in the estate of her predeceased aunt was discounted to reflect the nuisance value of a will contest that existed as of the date of the aunt's death.

11. Farm machinery. The regulations require that farm machinery be itemized and the value of each be separately returned. Treas. Reg. §20.2031-1(b).

12. Household goods and effects.

a. Value. The regulations provide that the value should be "[t]he fair market value of the decedent's household and personal effects is the price which a willing buyer would pay to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. §20.2031-6(a).

b. Itemized list required. The regulations state:

> "A room-by-room itemization of household and personal effects is desirable. All the articles should be named specifically, except that a number of articles contained in the same room, none of which has a value in excess of $100, may be grouped. A separate value should be given for each

> article named." Treas. Reg. §20.2031-6(a).

As long as no article exceeds $3,000, this is an acceptable procedure for valuing household goods.

c. Appraisals. In lieu of the itemized list procedure described above, the regulations provide:

> "[T]he executor may furnish a written statement, containing a declaration that it is made under penalties of perjury, setting forth the aggregate value as appraised by a competent appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personalty involved." Treas. Reg. §20.2031-6(a).

This procedure is applicable where there is no single object over $3,000 in value.

d. Appraisal requirements For the appraisal requirements where there is an item in excess of $3,000, see VIII.A.1. above.

e. General requirements for appraisers. If expert appraisers are employed, either where required or voluntarily, the regulations state "care shall be taken to see that they are reputable and of recognized competency to appraise the particular class of property involved." Treas. Reg. §20.2031-6(d).

f. Early disposition of household goods. Often there is a desire to dispose of the household goods either by distribution or by sale prior to receipt of the estate tax closing letter or an audit and inspection by the IRS auditing agent. There is a procedure, little complied with, in the regulations for when an early disposition is to take place.

> "c. *Disposition of household effects prior to investigation*. If it is desired to effect distribution or sale of any portion of the household or personal effects of the decedent in advance of an investigation by an officer of the Internal Revenue Service, information to that effect shall be given to the district director. The statement to the district director shall be accompanied by an appraisal of such property, under oath, and by a written statement of the executor, containing a declaration that it is made under the penalties of perjury, regarding the completeness of the list of such property and the qualifications of the appraiser, as heretofore described. If a personal inspection by an officer of the Internal Revenue Service is not deemed necessary, the executor will be so advised. This procedure is designed to facilitate disposition of such property and to obviate future expense and inconvenience to the estate by affording the district director an opportunity to make an investigation should one be deemed necessary prior to sale or distribution." Treas. Reg. § 20.2031-6(c).

13. Insurance on life of another. For each life insurance policy on the life of a person other than the decedent, a Form 712 needs to be requested from the insurance company. Form 706, p. 20. For a policy on a living person, the back side of the form is completed. The value will be the interpolated terminal reserve of the policy, plus the unearned premium, less any policy loan.

a. Single premium or paid-up policies. The instructions contain special provisions for single premium or paid up policies.

> "In certain situations, for example where the surrender value of the policy exceeds its replacement cost, the true economic value of the policy will be greater than the amount shown on line 56 of Form 712. In these situations, you should report the full economic value of the policy on Schedule F. See Rev. Rul. 78-137, 1978-1CB 280 for details." Form, p. 20.

b. Alternate valuation. If the decedent owned life insurance on the life of another who dies within six months of the decedent, election of alternate valuation will cause the full face value of the insurance policy to be included in the estate. Rev. Rul. 63-52, 1963-1 C.B. 173.

c. Split-dollar insurance. Where the decedent owns a split-dollar policy on the life of another, the value of the policy that is includible on the decedent's gross estate, for purposes of IRC Section 2031(a), is the interpolated terminal reserve plus the proportionate part of the gross premium paid before the date of the decedent's death that covers the period extending beyond that date, reduced by the amount of the corporation's interest in the policy. Rev. Rul. 79-429, 1979-2 C.B. 321.

14. Jewelry. The regulations state that the fair market value of an item of property is not to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. If the item is generally obtained by the public in the retail market, then the fair market value of such item is the price at which it would be sold at retail. Treas. Reg. § 20.2031-1(b). Because of the wide variation in prices between retail and wholesale for jewelry, the appraiser must take care that values are based on prices in which the estate could participate if it were to sell the item.

In *M. Lemann Estate*, 94-1 USTC ¶60, 159 (D.C. La 1994) it was held that the fair market value of jewelry was the price at which the items would be sold at retail. The government's appraisals were accepted because they were based on comparable auction sales, while the estate's appraisal's were rejected because they were not based on comparable sales but were akin to what a jeweler would pay.

Does it seem fair that the proper market in which you value jewelry is what a jeweler would sell the jewelry for? To this author, it seems that the IRS penalizes a person for having jewelry. In *Lemann*, the court reasoned that the fair market value of an automobile is the price at which an automobile of the same or approximately the same description, model, age, condition, etc. could be purchased by a member of the general public. Such price would not be the price for which the automobile would be purchased by a dealer in used automobiles. *Id.*

See the discussion above in Paragraph 2, "Automobiles," regarding deduction of selling expenses under Treas. Reg. § 20.2053-3(d)(2) where an item is required to be sold.

15. Livestock. The regulations require that livestock be itemized and the value of each be separately returned. Treas. Reg. §20.2031-1(b).

16. Marital deduction (Section 2044) property. Property of all kinds, whether real estate, stocks and bonds, mortgages, notes and cash, or whatever, which is Section 2044 property, property subject to a marital deduction in the estate of the decedent's previously deceased spouse or by lifetime gift to the decedent from the decedent's spouse, are properly reported on Schedule F.

The instructions with the form, states:

> "If the decedent was a surviving spouse, he or she may have received qualified terminal interest property (QTIP) from the predeceased spouse for which the marital deduction was elected either on the predeceased spouse's estate tax return or on a gift tax return, Form 709. The election was available for gifts made and decedents dying after December 31, 1981. List such property on Schedule F." Form, p. 20.

On page 2 of the form, information is solicited regarding the decedent's *last* marriage. The decedent could be survived by a spouse, and also have Section 2044 property from a prior marriage. The preparer should make inquiry regarding Section 2044 property from the last marriage or any prior marriage.

a. Valuation. The instructions with the form provide that if the decedent retained his or her interest in the QTIP property at death, the full value of the QTIP property is includible in his or her estate, even though the qualifying income interest terminated at death. It is valued as of the date of the decedent's death or the alternate valuation date, as applicable. Value is not reduced by any annual exclusion that may hve applied to the transfer creating the interest. Form p. 20.

b. Passing from decedent. QTIP property is treated as passing from the decedent, and according to the instructions, if it otherwise meets the requirements, the interest can qualify for the charitable and marital deduction. Form, p. 20. One of the major reasons for creating QTIP property is so it will not pass to decedent's surviving spouse, but it qualifies for the marital deduction in the incredible circumstance of it so passing.

c. Duty of consistency. *Letts Estate v. Comm'n*, 109 TC No. 15, involved the estate of the second spouse. When husband died, the executor mistakenly claimed a marital deduction for property husband left in trust for his wife, without electing to treat the interest as qualified terminable interest property. Husband's estate tax return was not examined by the IRS and the time to assess tax against his estate expired. When wife died, the executor (same for both estates) concluded that the interest that husband left to wife was not properly QTIP property and so the executor did not include the value of the trust property in the wife's estate by not including it on the estate tax return. The tax court held that the duty of consistency applied to prevent the wife's estate from benefitting in a later year from an error or omission in an earlier year that cannot be corrected because the time to access tax for the earlier year has expired.

d. Clinton Revenue Proposal. The President's 1998 revenue proposal notes that some taxpayers have attempted to "whipsaw" the government by claiming the marital deduction for QTIP property in the first estate and then after the statute of limitations for assessing tax on the first estate has elapsed, arguing against inclusion under section 2044 in the second estate due to some technical flaw in the QTIP eligibility or election in the first estate. The revenue proposal would amend section 2044 to provide that if a marital deduction in allowed with respect to QTIP property under section 2523(f) or 2056(b)(7), inclusion is required in the beneficiary spouses estate under section 2044. General Explanation of the Administration's Revenue Proposals, February 1998, p. 132. The President's proposal states that it would be effective for decedent's (i.e., surviving spouses) dying after the date of enactment, suggesting that the whipsaw is permitted under current law.

17. Oriental rugs. When an appraisal is involved, the regulations provide, "In the case of oriental rugs, the size, make and general condition shall be given." Treas. Reg. §20.2031-6(d).

18. Paintings. When an appraisal is involved, the regulations provide, "In listing paintings having artistic value, the size, subject, and artist's name shall be stated." Treas. Reg. §20.2031-6(d).

In *R. Seull Est.,* 67 TCM 2953, works of art sold at auction were valued at the hammer price plus a buyer's commission less a discount reflecting appreciation from the date of death to the date of sale.

19. Remainder interest. These are valued by the use of standard or special section 7520 actuarial factors, as provided in Treas. Reg. §20.2031-7(d).

a. Alternate valuation. If the alternate valuation method is used, the values of remainder interests, life estates and similar interests are figured using the age of the recipient on the date of the decedent's death and the value of the property on the alternate valuation date. Instructions, p.3.

20. Section 2044 property. Schedule F is where QTIP property that the decedent received from his or her spouse is reported. The instructions state,

> "If this [QTIP] election was made and the surviving spouse retained his or her interest in the QTIP property at death, the full value of the QTIP property is includible in his or her estate, even though the qualifying income interest terminated at death. It is valued as of the date of the surviving spouse's death, or alternate valuation date, if applicable. Do not reduce the value by any annual exclusion that may have applied to the transfer creating the interest."
>
> "The value of such property included in the surviving spouse's gross estate is treated as passing from the surviving spouse. It therefore qualifies for the charitable and marital deductions on the surviving spouse's estate tax return if it meets the other requirements for those deductions."

21. Silverware. When an appraisal is involved, the regulations, Treas. Reg. §20.2031-6(d) provide special rules for silverware.

a. Information required. "Sets of silverware shall be listed in separate groups. Groups or individual pieces of silverware shall be weighed and weights given in troy ounces."

b. Value. "In arriving at the value of silverware, the appraisers shall take into consideration its antiquity, utility, desirability, condition, and obsolescence." This provision either conflicts with or is redundant with the general guidance that value is the price that a willing buyer would pay to a willing seller.

22. Tax refund claims. Special care needs to be taken to determine the tax situation as of the date of death, because a liability can be deducted as a debt. For an overpayment, the gross estate should include the refund and any interest that may have accrued as of the date of death. Interest earned after the date of death is not included in the gross estate. See *Bank of California v. Comm.*, 133 F.2d 428 (9th Cir. 1943) where it was held to be error to include in the estate the entire amount of an income tax refund eventually recovered less only the interest accumulating after decedent's death. The proper value was the fair market value as a claim at decedent's death.

23. Trust funds, shares in. The instructions request that a copy of the trust instrument be attached. Form, p. 20.

C. On audit. The examining agent is to make sure that the items returned are consistent with the decedent's financial and social position. Examiner's Handbook, Section (11)10(2). The examiner is to examine the following sources of information in determining whether household goods are fully reported:

> "(a) examiner's knowledge of decedent's social standing in the community;
>
> "(b) inspection of the residence and its furnishings, if still intact and undistributed;
>
> "(c) submitted appraisals;
>
> "(d) personal property tax assessment sheets in States having a personal property tax;
>
> "(e) inspection of insurance policies covering household goods, including endorsements for valuable items (this may give an indication of total value);
>
> "(f) cancelled checks made in payment of household furnishings (this technique may be employed in cases where inspection of cancelled checks for several years is being made in connection with some other issue in the return, as, for example, the amount of adjusted taxable gifts). These records may also disclose insurance policies for tangible personal property not listed in the household goods policy;
>
> "(g) if household furnishings have been sold, a complete listing with sales prices will usually be obtainable;
>
> "(h) decedent's home and furnishings may have been described and photographed in a magazine or in the local newspaper;
>
> "(i) decedent's will may mention specific items of household goods, such as antique furniture, objects of art, silverware, etc.
>
> "(j) probate court files may disclose a complete list of household goods;
>
> "(k) the decedent's forms 1040 may disclose gifts to charity of valuable personal property, such as antique furniture, indicating the type of assets which the decedent should have owned at the time of death;
>
> "(l) the beneficiaries of the decedent's estate may have taken substantial charitable deductions for the contribution to charity of decedent's personal effects, even though those items were returned at nominal estate tax values. In such situations, appropriate adjustments should be made."

IX. Schedule G--Transfers During Decedent's Life

A. When completed. Schedule G must be completed if the decedent made any of the lifetime transfers required to be listed on the schedule or if the answer is "yes" to the questions in Part 4, Questions 11 or 12a.

"11. Did the decedent make any transfers described in section 2035, 2036, 2037 or 2038 (see the instructions for Schedule G)?"

"12. Were there in existence at the time of the decedent's death:

a. Any trusts created by the decedent during his or her lifetime?"

B. Information reported. The instruc- tions are extensive on the items that must be reported on Schedule G, including:

(i) Certain gift taxes, IRC Section 2035(c).

(ii) Certain transfers within 3 years before death, IRC Section 2035(a).

(iii) Transfers with retained life estate, Section 2036.

(iv) Transfers taking effect at death, Section 2037.

(v) Revocable transfers, Section 2038.

1. Certain gift taxes, IRC Section 2035(c). Gift taxes paid by the decedent or decedent's estate on gifts made within three years of the date of decedent's death by the decedent or the decedent's spouse are included in the estate for estate tax purposes.

According to the instructions, the date of the gift, not the date of payment of the gift tax, determines whether the gift tax is included. If the decedent died on July 10, 1998, gift taxes attributable to gifts made before July 10, 1995, are not includible in the gross estate. Instructions, p. 11.

The preparer should examine the Forms 709 filed by the decedent and the decedent's spouse to determine what part of the gift taxes is attributable to gifts made within three years before death.

An explanation of how the includible gift taxes were computed is to be attached where the Form 706 does not include the entire gift taxes shown on any Form 709 filed for gifts made within 3 years of death. Instructions, p. 11. In TAM 9729005, the IRS ruled that for purposes of IRC Section 2035(c), the decedent paid the gift tax on transfers made by the decedent and his spouse during the three-year period ending on the date of death. Decedent gave his spouse the amount of each taxable gift in a check that was deposited the day before she wrote a gift check. The decedent also gave his spouse the amount of gift taxes payable on the gifts two days prior to payment. The ruling cited *Estate of Cidulka v. Comm.*, T.C. Memo 1996-149.

2. Certain transfers within 3 years before death, IRC Section 2035(a).

a. Transfers of insurance. Include any transfer by the decedent with respect to a life insurance policy within three years before death.

(1) Insurance on decedent. For insurance on the life of decedent, the amount includible and the information required are determined using the instructions to Schedule D. Forms 712 are attached.

(2) Insurance on life of another. For insurance on the life of another, the amount includible and the information required are determined using the instructions to Schedule F. Forms 712 are attached.

b. Other transfers. Any transfer within 3 years before death of a retained IRC Section 2036 life estate, IRC Section 2037 reversionary interest, or IRC Section 2038 power to revoke, is included if the property subject to the life estate, interest, or power would have been included in the gross estate had the decedent continued to possess the life estate, interest or power until death.

(1) How reported. These transfers are reported on Schedule G regardless of whether a gift tax return was required to be filed for them when they were made. The amount includible and the information required are set forth below in the following descriptions for IRC Sections 2036, 2037, and 2038.

(2) Excluded transfers. The IRS has treated annual exclusion gifts made directly from a revocable trust within three years of death as included within the estate for estate tax purposes. The Taxpayer Relief Act of 1997 reverses the IRS position with respect to gifts made by decedents dying after the date of enactment, August 5, 1997.

3. Transfers with retained life estate, IRC Section 2036.

a. Included transfers. Transfers by the decedent in which the decedent retained an interest in the transferred property are included under IRC Section 2036. This section applies to the following retained interests or rights:

i) The right to income from the transferred property.

ii) The right to possession or enjoyment of the property.

iii) The right, either alone or with

any person, to designate the persons who shall receive the income from, or possess or enjoy the property.

The transfer can be in trust or otherwise, but excludes bona fide sales for adequate and full consideration. Instructions p. 11.

b. Amount included. "The amount includible in the gross estate is the value of the transferred property at the time of the decedent's death. If the decedent kept or reserved an interest or right to only a part of the transferred property, the amount includible in the gross estate is a corresponding part of the entire value of the property." Instructions, p. 11.

c. Enforceability. According to the instructions, the retained interest does not have to be legally enforceable to be included in decedent's estate. What matters is that a substantial economic benefit was retained. The instructions illustrate as follows:

> "[I]f a mother transferred title to her home to her daughter but with the informal understanding that she was to continue living there until her death, the value of the home would be includible in the mother's estate, even if the agreement would not have been legally enforceable." Instructions, p. 11.

See discussion of "Sales and leasebacks" below.

d. Reservation of powers. In Rev. Rul. 95-58, I.R.B. 1995-36, the Service revoked Rev. Rul. 79-353, 1979-2 C.B. 325, and Rev. Rul. 81-51, 1981-1, C.B. 458, which held that the reservation by a decedent settlor of the unrestricted power to remove a corporate trustee and appoint a successor corporate trustee was equivalent to the decedent settlor's reservation of the trustees' discretionary powers. The Service has accepted the court decisions in *Estate of Wall*, 101 TC 300, and *Estate of Vak*, 973 F2d 1409, 1992-2 USTC ¶60,110 (8th Cir. 1992). This ruling also modified Rev. Rul. 77-182, 1977-1 C.B. 273, to provide that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate trustee that was not related or subordinate to the decedent, within the meaning of Section 672(c), decedent would not be deemed to have retained the trustee's discretionary powers. The ruling expands the holding of the court in the *Estate of Wall* to include the removal and appointment of individual trustee but adds a requirement that the successor not be related or subordinate to the donor to avoid the adverse estate tax consequences.

e. Reciprocal trust doctrine. *Estate of Green v. U.S.* 68 F.3d 151, 95-2 USTC ¶60,216 (6th Cir. 1995), involved a rejection of an IRS effort to impose the reciprocal trust doctrine. The reciprocal trust doctrine permits the IRS to realign the parties who create identical trusts in order to treat each party as one with a retained life estate under Code Section 2036(a)(1).

Husband and wife had two grandchildren. Husband created an irrevocable trust designating his wife as trustee for one granddaughter, and wife created a trust designating her husband as trustee for the other granddaughter. The trust agreements were substantially identical and the trustee could not alter, amend, or revoke the trust. The trustee had discretion to invest and to arrange the timing of distribution of trust corpus and income until each respective beneficiary reached age 21. Neither husband nor wife directly or indirectly retained or reserved any economic benefits from the assets or income of the trust. On the death of husband the government argued that the reciprocal trust doctrine should apply to cause includability of the assets of the trust created by husband in husband's gross estate. The Appeals Court held for the taxpayer. According to *United States v. Grace*, 395 U.S. 613 (1969), the criteria for applying the reciprocal trust doctrine are that (i) the trusts be interrelated and (2) the arrangement, to the extent of mutual value, leaves the trustors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries. In *Estate of Green*, the husband retained no economic value, nor did he receive any economic value in the trust established by his wife, so that the reciprocal trust doctrine was held inapplicable. In effect, the court held that if there was no retained economic benefit, the reciprocal trust doctrine did not apply. The Tax Court rejected a contrary position in *Bischoff v. Commissioner*, 69 TC 32 (1977).

f. Sale of remainder interest. In *Wheeler v. United States*, 96-1 USTC ¶ 60,226 (W.D., Texas 1996), a sale of a remainder interest in a homestead was involved. In 1984 the decedent sold the remainder interest in property to his two sons for the actuarial table value of the interest represented by a note. The decedent died seven years later. Citing *Gradow v. United States*, 878 F. 2d 516 (Fed. Cir. 1990) and *Pitman v. United States*, 878 F. Supp. 833, 95-1 USTC ¶ 60,186 (E.D.NC. 1994), the transaction was subjected to Section 2036(a)(1) which requires tax on the entire value of the property and not just the value of the remainder interest. The court found the transaction to be in substance a gift, not a sale. This case was recently affirmed by the Fifth Circuit. Because of Chapter 14, a sale of a remainder interest only works for collateral relatives.

Estate of *McClendon v. Commissioner*, 96-1 USTC ¶ 60,220 (5th Cir. 1996, opinion designated as "not for publication") also involved a sale of a remainder interests. This case involved the estate of Gordon R. McClendon, a Texas broadcaster. At issue were amendments to family limited partnership agreements and transfer of a remainder interest in partnership interests by the decedent in exchange for life annuities. The Tax Court recognized the validity of amendments to the partnership agreements but held the remainder interests assigned would be valued as partnership interests not as assigned interest. The Fifth Circuit reversed, holding that under restrictions in the partnership agreement, the rights assigned were those of an assignee, not a partner. The Tax Court also held that the life expectancy table could not be used to value the annuity on the theory the decedent was terminally ill when the annuity was structured.

In *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, the Third Circuit reversed the Tax Court, 105 T.C. 252 (1995), and upheld a sale of a remainder interest. Sales before October 9, 1990, the effective date of IRC § 2702 should continue to be reported as not included in the gross estate.

g. Sales and leasebacks. In *Estate of Maxwell*, 72 AFTR 2d ¶149,000 (2nd Cir. 1993) the Second Circuit upheld the tax court's holding that the decedent's residence should be included in her estate at its full date of death fair market value, even though she purportedly sold the residence to her son and his wife several years before his death. The transaction was structured as a sale-leaseback, but the court concluded that the parties never intended a sale to occur and the property must be included in the decedent's estate under IRC Section 2036(a).

A sale-leaseback transaction should not result in a retained interest where the sale and the lease are on terms that are otherwise at arms length and the transactions do not contain an element of gift.

h. Custodial gifts. Transfers to minors where the decedent is both the donor and the custodian will be includible in the decedent's gross estate if the decedent dies before the donee reaches majority. Rev. Rul. 57-366, 1957-2 C.B. 618, Rev. Rul. 59-357, 1959-2 C.B. 212. Includability is required where the decedent is successor custodian and regardless of whether the decedent named himself or herself as initial custodian or subsequently is appointed custodian. Rev. Rul. 70-348, 1970-2 C.B. 193.

i. Retained voting rights. The Instructions, p. 11, set forth the so called anti-Byrum rule of IRC Section 2036 (b):

> "Transfers with a retained life estate also include transfers of stock in a "controlled corporation" after June 22, 1976, if the decedent retained or acquired voting rights in the stock. If the decedent retained direct or indirect voting rights in a controlled corporation, the decedent is considered to have retained enjoyment of the transferred property. A corporation is a "controlled corporation" if the decedent owned (actually or constructively) or had the right (either alone or with any other person) to vote at least 20% of the total combined voting power of all classes of stock. See section 2036(b). If these voting rights ceased or were relinquished within 3 years before the decedent's death, the corporate interests are included int he gross estae as if the decedent had actually retained the voting rights until death."

4. Transfers taking effect at death, IRC Section 2037.

The gross estate includes the value of property which the decedent transferred if possession or enjoyment of the property requires surviving the decedent and the decedent retained a reversionary interest in the property and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property. If the transfer was made before October 8, 1949, the reversionary interest must have arisen by the express terms of the instrument or transfer.

5. Revocable transfers, IRC Section 2038.

a. Instructions.

> "Revocable transfers (section 2038). The gross estate includes the value of transferred property in which the enjoyment of the transferred property was subject at decedent's death to any change through the exercise of a power to alter, amend, revoke, or terminate. A decedent's power to change the beneficiaries and to hasten or increase any beneficiary's enjoyment of the property are examples of this.
>
> "It does not matter whether the power was reserved at the time of the transfer whether it arose by operation of law, or was later created or conferred. The rule applies regardless of the source from which the power was acquired, and regardless of whether the power was exercisable by the decedent alone or with any person (and regardless of whether that person had a substantial adverse interest in the transferred property).
>
> "The capacity in which the decedent could use a power has no bearing. If the decedent gave property in trust and was the trustee with the power to revoke the trust, the property would be included in his or her gross estate. For transfers or additions to an irrevocable trust after October 28, 1979, the transferred property is includible if the decedent reserved the power to remove the trustee at will and appoint another trustee.
>
> "If the decedent relinquished within 3 years before death any of the includible powers described above, figure the gross estate as if the decedent had actually retained the powers until death.
>
> "Only the part of the transferred property that is subject to the decedent's power is included in the gross estate.
>
> "For more detailed information on which transfers are includible in the gross estate, see the Estate Tax Regulations." Instructions, pp. 11-12.

a. Possible revocable transfers. In the *Estate of Kisling v. Commissioner*, 32 F.3d 1222 (Eighth Cir. 1994), the decedent had transferred interests in a revocable trust within three years of death. The decedent also had the power under the trust to assign interests irrevocably. Reversing the Tax Court, the Eighth Circuit held the three-year rule under Section 2035 and 2038 did not apply. The IRS acquiesced to this decision in AOD 1995-006. The IRS indicates it will no longer pursue this issue where the decedent possesses a power to withdraw trust principal or distributions to himself regardless of whether the decedent also possesses a power to direct distribution to other distributees.

In LTR 9601002, assets were held in a revocable trust and the grantor also executed a durable power of attorney, which authorized the agent to make gifts. The agent withdrew assets from the trust to make gifts. Citing state (Oregon) law, the IRS held that the agent did not have the power to withdraw assets from the trust, since this was reserved to the trustor, individually. The power of attorney did not make reference to the trust. The drafting tip that comes from this letter ruling is that both the trust and the power of attorney should authorize the agent to make withdrawals and make gifts.

To a similar effect was *Estate of Goldman*, TC Memo 1996-29, which held that checks written to the decedent's daughter on the decedent's bank account under a power of attorney that did not explicitly authorize the making of gifts were includible in the decedent's gross estate. The decedent was terminally ill with cancer, and in November and in December of 1990 the decedent wrote several small gift checks herself. Her daughter also wrote checks, including gifts of $10,000 to each family member. In January the mother was gravely ill and the daughter wrote a series of similar gift checks, some of which were deposited after the death of the mother on January 17^{th}. The Tax Court held that the gifts made in 1990 and 1991 were incomplete on the grounds that the mother had been writing checks shortly before her death and that if she intended to make the gifts she would have written the checks herself. The opinion indicates that the court doubted the large gift checks dated 1990 were actually written that year and doubted that the decedent intended to make the gifts. The power of attorney did not give the daughter the power to make checks. This problem could have been avoided had the power of attorney authorized the daughter to make checks, or had the mother personally written the checks.

In *Estate of Halpern v. Commissioner*, TC Memo 1995-352, decedent was the beneficiary of a marital power of appointment trust created by her husband. In 1982 decedent's two sons recommended that she begin making annual exclusion gifts to reduce her taxable estate and her grandson suggested the gifts be made out of the marital trust. Gifts were made in 1982 through 1986 with all family members signing consents and indemnification agreements. In 1986 decedent suffered a stroke and was judged incompetent, but the gifts were continued in 1987 and 1988 with court approval. When decedent died in 1988, the IRS took the position that all the gifts distributed from the trust were includible in decedent's gross estate. Post-incompetency distributions were includible because the decedent did not consent to them and decedent could have challenged the distribution in state (Pennsylvania) court had she been capable of doing so. Her incapacity at that time was irrelevant.

In *M. Hubberd Est.*, TC ¶45,065(M), the decedent's gross estate was held to include voidable transfers of her limited partnership interests that were made by her attorney-in-fact prior to the decedent's death. The estate contended that the transfers were not includible in the gross estate because under Texas law, voidable transfers remain valid and vest title in the transferee until the transfer is successfully avoided, but here no one had taken action to void the transfers. The tax court held that under IRC Section 2038, the interest was includible because at decedent's death, the transferees' enjoyment of the property was subject to the decedent's power to revoke or terminate the voidable interests.

b. Reporting revocable trust assets. Assets held in a revocable trust, that would be reported as other assets in the decedent's probate estate had they not been transferred to the revocable trust, can be reported in a variety of ways:

a. The assets can be reported on Schedule G as appendages to the revocable trust listing on this schedule.

b. The assets can be reported on Schedule G as attachments to the schedule, with real estate; stocks and bonds; mortgages, notes and cash; life insurance and miscellaneous assets listed on separate attachments.

c. The assets can be listed on the other schedules with an indication that they are included in the trust listed on Schedule G. On Schedule G, list the other schedules and item numbers of assets included in the trust. The method does not appear to be consistent with the instructions that Section 2038 property be listed on Schedule G.

C. How reported.

1. Transfers reported. The instructions state that all transfers, other than outright transfers not in trust and bona fide sales, made by the decedent at any time during life must be reported on Schedule G regardless of whether they are believed to be subject to tax. Transfers not described above are to be reported on a statement attached to Schedule G. Instructions p. 12.

2. Required information. For each transfer, list the transferee, the date of the transfer, and give a complete description of the property. Instructions, p. 12.

3. Valuation. Transfers included in the gross estate should be valued on the date of the decedent's death, or if alternate valuation is adopted, according to Section 2032.

> "If only part of the property transferred meets the terms of section 2035(a), 2036, 2037, or 2038, then only a corresponding part of the value of the property should be included in the value of the gross estate. If the transferee makes additions or improvements to the property, the increased value of the property at the valuation date should not be included on Schedule G. However, if only a part of the value of the property is included, enter the value of the whole under the column headed "Description" and explain what part was included." Instructions, p. 12.

4. Trusts not included in estate. An irrevocable trust created by the decedent and not included in the decedent's estate should be listed on Schedule G with the value reported as zero.

5. Irrevocable life insurance trusts. These should be listed on Schedule G. The discussion of Schedule D addresses where the life insurance policies on decedent's life should be listed.

D. Attachments. The following should be attachments to the return.

1. For transfers in trust, copies of the trusts and all amendments. If the instrument is of public record, the copy should be certified, and if not of record, the copy should be verified.

2. Attachments for the asset that would be appropriate if the asset was listed on another schedule.

3. Copies of gift tax returns filed by the decedent's spouse for gifts made within three years of death.

4. An explanation of how includible gift taxes were computed if not all gift taxes are included for gifts shown on Form 709 for gifts within three years of death.

5. If the answer to Question 12a is "yes" a copy of the trust instrument for each trust must be attached. Instructions, p.6.

E. **On audit**. The agent is to look for policies transferred within three years of death by looking for cancelled checks of premium payments. Examiners' Handbook, Section (12) 30 (2). The examining agent is to look closely at gifts made by an incompetent decedent. *Id.* Section (12) 73 (4).

X. Schedule H.-- Powers of Appointment

A. When completed Schedule H must be attached if a "yes" answer is given to Part 4, question 13, "Did the decedent ever possess, exercise, or release any general power of appointment?" Form, p. 3. The instructions appear to expand on this and require a listing on Schedule H of any power of appointment, general or non-general.

B. Included in gross estate. Items listed on Schedule H and included in the gross estate are:

1. The value of property over which the decedent possessed a general power of appointment on the date of death; and

2. The value of property over which the decedent possessed a general power of appointment which the decedent exercised or released before death by disposing of it in such a way that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's gross estate as a transfer with a retained life estate, a transfer taking effect at death, or a revocable transfer. Instructions. p. 12.

C. Exceptions.

a. "Property subject to a power of appointment is not includible in the gross estate if the decedent released the power completely and the decedent held no interest in or control over the property." *Id.*

b. "If the failure to exercise a general power of appointment results in a lapse of the power, the lapse is treated as a release only to the extent that the value of the property that could have been appointed by the exercise of the lapsed power is more than the greater of $5,000 or 5% of the total value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could have been satisfied." *Id.*

D. General power of appointment.

1. Defined. A general power of appointment is a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate, except:

a. A power to consume, invade, or appropriate property for the benefit of the decedent that is limited by an ascertainable standard relating to health, education, support, or maintenance of the decedent.

b. A power (created after October 21, 1942) exercisable by the decedent only in conjunction with (a) the creator of the power, or (b) a person who has a substantial interest in the property subject to the power, which is adverse to the exercise of the power in favor of the decedent.

2. Partial powers. "A part of a power is considered a general power of appointment if the power:

a. May only be exercised by the decedent in conjunction with another person; and

b. Is also exercisable in favor of the other person (in addition to being exercisable in favor of the decedent, the decedent's creditors, the decedent's estate, or the creditors of the decedent's estate.)

"The part to include in the gross estate as a general power of appointment is figured by dividing the value of the property by the number of persons (including the decedent) in favor of whom the power is exercisable."
Instructions, p. 12.

3. Examples.

a. General power of appointment marital trust. The decedent may be a beneficiary of a general power of appointment marital trust established by a predeceased spouse.

b. General power of appointment trusts. The decedent may have a general power of appointment under a Section 2503(c) trust, under a trust established by a grandparent to qualify as a direct skip or under a trust established by a parent to avoid the generation skipping transfer tax. The power may be over the whole or it may be dependent upon a formula.

c. Five and five powers. A power to withdraw funds from a trust, limited to the greater of $5,000 or five percent, does not require inclusion of the whole trust but does require inclusion of the greater of $5,000 or five percent, if not exercised that year. IRC Section 2041(b)(2).

(1) In *Estate of Kurz v. Commissioner*, 68 F.3d 1027, 95-2 U.S.T.C. ¶ 60, 215 (7th Cir. 1995), according to the court a case of first impression as to stacked trusts, involved a finding that the decedent held a general power of appointment over a portion of the family trust. The will of the decedent's predeceased husband established two trusts of which the wife was the income beneficiary. From the marital trust, wife was entitled to as much of the principal as she wanted. Under the family trust, she could withdraw 5% in any year, but only if the marital trust was exhausted. Upon the death of wife, the marital trust contained $3.5 million and the family trust was $3.4 million. Wife's estate tax return included the value of the marital trust, but none of the family trust. The Tax Court held that the wife possessed a general power of appointment over 5% of the family trust requiring inclusion of 5% of $3.4 million, or $170,0000, in wife's estate under Code Section 2041(a)(2). The 7th Circuit affirmed the Tax Court opinion. Wife held economic dominion over all funds that could be withdrawn at any given moment. At the moment of her death, she could have withdrawn all of the marital trust and 5% of the family trust, after notifying the trustee of her wish to do so. Section 2041 is designed to include in the taxable estate all assets that the decedent possessed or effectively controlled.

(2) In *Estate of Myrtle V. Dietz*, 72 TCM 1058 (1996), the tax court ruled that a power of withdrawal equal to the greater of $5,000 or 5 percent of the trust principal unexercised for the year of death was included in the decedent's gross estate, rejecting the estate's argument that it was not included because of IRC Section 2041(b)(2).

d. Custodial powers. If decedent is custodian of a transfer of which the decedent is also the parent of the minor donee, even if the decedent is not the donor, the ability to use the custodial funds to discharge the obligation of support may be an IRC Section 2041 general power of appointment, and should be listed on Schedule H.

E. Attachments. A certified or verified copy of the instrument granting *any* power of appointment (general or non-general) possessed by the decedent is to be attached, along with a certified or verified copy of any instrument by which the power was exercised or released. These copies are to be attached even though it is contended that the power is not a general power of appointment and contended that the property is not included in the gross estate.

The Instructions, p. 12, contain the following definitions of "powers of appointment."

> "A power of appointment determines who will own or enjoy the property subject to the power and when they will own or enjoy it. The power must be created by someone

other than the decedent. It does not include a power created or held on property transferred by the decedent."

"A power of appointment includes all powers which are in substance and effect powers of appointment regardless of how they are identified and regardless of local property laws. For example, if a settlor transfers property in trust for the life of his wife, with a power in the wife to appropriate or consume the principal of the trust, the wife has a power of appointment."

"Some powers do not in themselves constitute a power of appointment.

"For example, a power to amend only administrative provisions of a trust that cannot substantially affect the beneficial enjoyment of the trust property or income is not a power of appointment. A power to manage, invest, or control assets, or to allocate receipts and disbursements, when exercised only in a fiduciary capacity, is not a power of appointment."

F. On audit. The examining agent on audit is to look at the following to find unreported powers of appointment.

"(a) the decedent - donee's will or prior wills may refer to such power; ...

"(d) your review of the decedent's income tax returns may disclose income from property subject to a power;

"(e) a review of a previous estate may disclose a power in favor of the present decedent." Examiner's Handbook, Section (13)20.

XI. Schedule I.-- Annuities.

A. When completed. Schedule I must be completed and filed if a "yes" answer is given to Part 4, Question 15, "Was the decedent, immediately before death, receiving an annuity described in the 'General' paragraph of the instructions to Schedule I?" All annuities in which the decedent had any interest must be disclosed on Schedule I.

B. Definitions.

1. Annuity. "The term 'annuity' includes one or more payments extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic." Instructions, p. 13. This definition is overly broad, because it would include payments under a promissory note or a contract to perform services, which are not annuities.

The instructions give this incomplete list of examples of contracts for annuities that must be included in the gross estate.

□ A contract under which the decedent immediately before death was receiving or was entitled to receive, for the duration of life, an annuity with payments to continue after death to a designated beneficiary, if surviving the decedent.

□ A contract under which the decedent immediately before death was receiving or was entitled to receive, together with another person, an annuity payable to the decedent and the other person for their joint lives, with payments to continue to the survivor following the death of either.

□ A contract or agreement entered into by the decedent and employer under which the decedent immediately before death and following retirement was receiving or was entitled to receive, an annuity payable to the decedent for life and after the decedent's death to a designated beneficiary, if surviving the decedent, whether the payments after the decedent's death are fixed by the contract or subject to an option or election exercised or exercisable by the decedent. (This may be modified as provided in "Annuities Under Approved Plans.")

□ A contract or agreement entered into by the decedent and the decedent's employer under which at the decedent's death, before retirement, or before the expiration of a stated period of time, an annuity was payable to a designated beneficiary, if surviving the decedent. (This may be modified as provided in "Annuities Under Approved Plans.")

□ A contract or agreement under which the decedent immediately before death was receiving, or was entitled to receive, an annuity for a stated period of time, with the annuity to continue to a designated beneficiary, surviving the decedent, upon the decedent's death and before the expiration of that period of time.

□ An annuity contract or other arrangement providing for a series of substantially equal periodic payment to be made to a beneficiary for life or over a period of at least 36 months after the date of the decedent's death under an individual retirement account, annuity, or bond as described in IRC Section 2039(e) (before its repeal).

2. Payable to the decedent. An annuity or other payment was payable to the decedent if, at the time of death, the decedent was in fact receiving an annuity or other payment, with or without an enforceable right to have the payments continued. Instructions, p. 13.

3. Right to receive an annuity. The decedent had the right to receive an annuity or other payment if, immediately before death, the decedent had an enforceable right to receive payments at some time in the future, whether or not at the time of death the decedent had a present right to receive payments. *Id.*

C. Annuities to be reported. The instructions refer to two types of annuities that must be reported: those described in the "General" paragraph and those described in paragraphs a to h of "Annuities Under Approved Plans."

1. General. The instructions state that the gross estate must include all or part of the value of any annuity that meets the following requirements:

i) It is receivable by a beneficiary following the death of the decedent and by reason of surviving the decedent;

ii) The annuity is under a contract or agreement entered into after March 3, 1931;

iii) The annuity was payable to the decedent (or the decedent possessed the right to receive the annuity) either alone or in conjunction with another, for the decedent's life or for any period not ascertainable without reference to the decedent's death or for any period that did not in fact end before the decedent's death;

iv) the contract or agreement is not a policy of insurance on the life of the decedent.

2. Annuities under approved plans. The instructions state that approved plans may be separated into two categories, with different exclusion rules applying to the two categories of plans:

i) Pension, profit-sharing, stock bonus, and other similar plans, and

ii) Individual retirement arrangements (IRAs) and retirement bonds.

For pension, profit-sharing, stock bonus and other similar plans, the following plans are approved for the exclusion rules:

a. An employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan that meet all the requirements of section 401(a), either at the time of the decedent's separation from employment (whether by death or otherwise) or at the time of the termination of the plan (if earlier).

b. A retirement annuity contract purchased by the employer (but not by an employees' trust) under a plan that, at the time of the decedent's separation from employment (by death or otherwise), or at the time of the termination of the plan (if earlier), was a plan described in section 403(a).

c. A retirement annuity contract purchased for an employee by an employer that is an organization referred to in section 170(b)(1)(A)(ii) or (vi), or that is a religious organization (other than a trust), and that is exempt from tax under section 501(a).

d. Chapter 73 of Title 10 of the United States Code.

e. A bond purchase plan described in section 405 (before its repeal by P.L. 98-369, effective for obligations issued after December 31, 1983).

For IRAs and retirement bonds, the following plans are approved plans for the exclusion rules:

f. An individual retirement account described in IRC section 408(a);

g. An individual retirement annuity described in IRC Section 408(b).

h. A retirement bond described in IRC Section 409(a) before its repeal by P.L. 98-369).

If data available to the preparer does not indicate whether the plan satisfies the requirements of IRC Section 401(a) [paragraph a], 403(a) [paragraph b], 408(a) [paragraph f], 408(b) [paragraph g], or 409(a) [paragraph h], that information may be obtained from the District Director of the Internal Revenue for the district where the employer's principal place of business is located. Most plan administrators will be able to inform the Form 706 preparer whether the plan satisfies the IRC requirements.

3. Applicability. These rules apply to all types of annuities, including pension plans, individual retirement arrangements, and purchased commercial annuities.

4. Amounts excluded.

a. Up to $100,000. Up to $100,000 can be excluded if the decedent either:

i) On December 31, 1984, was both a participant in the plan and in pay status (ie., had received at least one benefit payment on or before December 31, 1984), and had irrevocably elected the form of the benefit before July 18, 1984; or

ii) Had separate from service before January 1, 1985, and did not change the form of benefit before death.

b. Over $100,000. The amount excluded can exceed $100,00 if either:

i) On December 31, 1982, the decedent was both a participant in the plan and in pay status (i.e., had received at least one benefit payment on or before December 21, 1982), and the decedent irrevocably elected the form of the benefit before January 1, 1983; or

ii) The decedent separate from service before January 1, 1983, and did not change the form of benefit before death.

5. Receivable by the executor. If any part of an annuity under a plan described in paragraphs **a** to **h** above is receivable by the executor in that capacity, it is generally includible in the gross estate on Schedule I to the extent that it is so received. In general, the annuity is receivable by the executor if it is to be paid to the executor or if there is an agreement (expressed or implied) that it will be applied by the beneficiary for the benefit of the estate (such as in discharge of the estate's liability for death taxes or debts of the decedent, etc.) Or that its distribution will be governed to any extent by the terms of the decedent will or the laws of descent and distribution. Instructions, pp. 13-14.

6. Exclusion rules for pension, profit-sharing, stock bonus, and other similar plans.

a. No decedent contributions. If an annuity under an "approved plan" described in paragraphs **a** to **e** above is receivable by a beneficiary other than the executor and the decedent made no contributions under the plan toward the cost, no part of the value of the annuity, subject to the $100,000 limitation (if applicable), is includible in the gross estate.

b. Decedent contributions. If the decedent made a contribution under a plan described in paragraphs **a** to **e** above toward the cost, the amount included in the gross estate on Schedule I is that proportion of the value of the annuity which the amount of the decedent's contribution under the plan bears to the total amount of all contributions under the plan The remaining value of the annuity is excludible from the gross estate subject to the $100,000 limitation (if application). The rules to determine whether the decedent made contributions to the plan are set forth under the regulations to IRC Section 2039.

7. Exclusion rules for IRAs and retirement bonds. Plans described in paragraphs f to h are approved plans only if they provide for a series of substantially equal periodic payments made to a beneficiary for life, or over a period of at least 36 months after the date of the decedent's death.

If an annuity under a plan described in paragraph f to h above is receivable by a beneficiary other than the executor, the entire value of the annuity is excludible from the gross estate even if the decedent made a contribution under the plan, subject to the $100,000 limitation, if applicable.

If any payment to or for an account or annuity described in paragraphs f to h above was not allowable as an income tax deduction under section 219 (and was not a rollover contribution as described in section 2039(e) before its repeal), include in the gross estate on Schedule I that proportion of the value of the annuity which the amount not allowable as a deduction under section 219 and not a rollover contribution bears to the total amount paid to or for such account or annuity. More information is set forth in Treas. Reg. $20.2039-5.

8. Lump sum distribution election. The instructions provide:

> "The election pertaining to the lump sum distribution from qualified plans (approved plans) excludes from the gross estate all or part of the lump sum distribution that would otherwise be includible. When the recipient makes the election to take a lump sum distribution and include it in his or her income tax, the amount excluded from the gross estate is the portion attributable to the employer contributions. The portion, if any attributable to the employee-decedent's contributions is always includible. The actual election is made by the recipient of the distribution by taking the lump sum distribution and by treating it as taxable on his or her income tax return as described in Regulations section 20.2039-f(d). The election is irrevocable. However, you may not compute the gross estate in accordance with this election unless you check "Yes" to line A and attach the name, address, and identifying number of the recipients of the lump sum distributions. See regulations section 20.2039-4." Instructions, p. 14.

D. Amount included.

1. Decedent contributions. If the decedent contributed only part of the purchase price of the contract or agreement, the gross estate includes only that part of the value of the annuity receivable by the surviving beneficiary that the decedent's contribution to the purchase price of the annuity or agreement bears to the total purchase price. The instructions give this example:

> "[I]f the value of the survivor's annuity was $20,000 and the decedent had contributed three-fourths of the purchase price of the contract, the amount includible is $15,000 (3/4 x $20,000)." Instructions, p. 13

2. Employer contributions. Contributions made by the decedent's employer to the purchase price of the contract or agreement are considered made by the decedent if they were made by the employer because of the decedent's employment, with the important exceptions of annuities described in the instructions in "Annuities Under Approved Plans." Instructions, p. 13.

3. Not includible. The instructions state that an annuity contract that provides periodic payments to a person for life and ceases at the person's death is not includible in the gross estate. Social Security benefits are not includible in the gross estate even if the surviving spouse receives benefits. Instructions, p.13. But, the instructions caution that an annuity or other payment that is not includible in the decedent's gross estate as an annuity may still be includible under some other applicable provision of the law, such as a power of appointment. *Id.* Also if the decedent retired before January 1, 1985, part or all of the annuity may be excluded, discussed below.

4. Marital deduction. An annuity payable to the decedent's surviving spouse may qualify for the marital deduction, such that the marital deduction removes the tax consequence of includibility.

E. Required Information.

1. Description. Give the name and address of the grantor of the annuity, and specify if the annuity is under an approved plan. State the ratio of the decedent's contribution to the total purchase price of the annuity, in these instances:

i) if it is under an approved plan.

ii) if the decedent was employed at the time of death and an annuity ("a contract or agreement entered into by the decedent and the decedent's employer under which at the decedent's death, before retirement, or before the expiration of a stated period of time, an annuity was payable to a designated beneficiary, if surviving the beneficiary") became payable to any beneficiary because the beneficiary survived the decedent.

2. Annuity from an IRA. If an annuity under an individual retirement account or annuity became payable to any beneficiary because that beneficiary survived the decedent and is payable to the beneficiary for life or for at least 36 months following the decedent's death, the return must state the ratio of the amount paid for the individual retirement account or annuity that was not allowable as an income tax deduction under section 219 (other than a rollover contribution) to the total amount paid for the account or annuity. *Id.*

3. Payable out of trust. If the annuity is payable out of a trust or other fund, the description should be sufficiently complete to fully identify it.

4. Term of years. If the annuity is payable for a term of years, include the duration of the term and the date on which it began, and if payable for the life of a person other than the decedent, include the date of birth of that person. *Id.*

5. Excluded amount. If the annuity is wholly or partially excluded from the gross estate, enter the amount excluded under "Description" and explain how the exclusion was computed. *Id.*

F. On audit. The examining agent is to review the decedent's Form 1040 to see if any annuity was reported or if IRA or Keogh plan deductions are taken. Examiners' Handbook, Section (14)10(9).

APPENDIX A

Valuation Softwre

Valuation software refers to software that gives the value of publicly traded securities and savings bonds.

The proper estate tax value of securities is usually not readily available from either brokerage firm account statements or statements from bank trust departments. Their reports usually give the closing value of publicly traded securities on the date of death or the last trading day before the date of death if death is not on a trading day.

For securities traded on the valuation date, the Treasury regulations require value based upon the mean between the high and the low price for that day. When the valuation date is not a trading date, the regulations require a weighted average of the mean of highs and lows on the last trading day before and the last trading day after the valuation date. Throw in securities traded ex-dividend and one may be confronted with numerous calculations to obtain values that meet IRS specifications.

Valuation software typically works by letting the user send by e-mail the number of shares and the CUSIP number for each security along with the valuation date to the valuation service provider. The valuation service provider sends the valuation information back. Some software programs permit direct input of the data into the Form 706 program while other programs will require that the data be keyed into the 706 program. Some valuation service providers also permit submission of CUSIP numbers and valuation date by fax or by mail, in addition to e-mail. One service permits obtaining valuation information from its CD-ROM.

A difficulty in obtaining security values through a valuation service is obtaining the CUSIP number. Subscription to a CUSIP location service is not yet cost effective for a small law firm. Sometimes the decedent's broker will provide the CUSIP numbers, or you may be able to impose on a friendly trust department. Another difficulty is that these valuation services generally will not provide values for bonds or securities that do not have CUSIP numbers assigned, which may be the case for bonds denominated in foreign currencies and securities traded solely on foreign exchanges.

One software program provides the value and accrued interest for U.S. savings bonds. The software comes on a diskette and all calculations are performed on the personal computer. It does not take very many savings bonds to make such software cost effective for calculating values and accrued interest.

The following are the software and service providers of which the author is aware. No warranty is made that the list is complete or that the information and prices are correct. They are presented in no particular order.

FDS Financial Data Service, Inc.
818-887-2019
818-348-9007 fax
6355 Topanga Canyon Blvd., Suite 407
Woodland Hills, CA 91367
www.financialdata.com
e-mail: financialdata@financialdata.com

Mail in and fax service for pricing securities is available.

On-Line system is based on a CD with CUSIP numbers and daily pricing for 40,000 commonly traded stocks, bonds and mutual funds. On-line search 3,000,000 municipal bonds, UITs, mortgage bonds, or CMOs.

CD is $1095 with monthly updates, $750 for quarterly updates, $375 for semiannual updates, and $250 for annual update, plus $1.15 for online search per security.

Appraise Evaluation Services, Inc.
(201) 784-8500
(201) 784-9685 fax
180 Old Tappan Road, Bldg. #4
Old Tappan, NJ 07675
www.appraise@nj.com

Mail, fax, or online service is available.

Estate valuations	Immediate	Overnight
Securities	$1.35	$1.20
Limited partnerships	12.00	12.00
CMOs	2.70	2.40

Software is $75 for one module, $125 for two modules, $175 for three modules, $200 for four modules, and $225 for five modules.

Estate Valuations & Pricing Systems, Inc

1-800-237-3440
818-313-6300
818-313-6313 fax
5855 Topanga Canyon Blvd., Suite 520
Woodland Hills, CA 91367
www.evpsys.com
e-mail: sales@evpsys.com

This company has a contract with the IRS to provide on-line automated valuation services of stocks and bonds for estate and gift tax returns.

Estate Val 5 is the DOS version and it works with Windows 3.1 and Estate Val 98 runs on Windows 95 and Windows NT. Estate Val 2000 comes on a CD ROM or can be downloaded from www.estateval.com, and it permits direct internet access.

The service covers equities, municipal bonds, mutual funds, savings bonds, corporate and government bonds, GNMAs, FNMAs, FHLMCs, CMOs, UITs, and U.S. Treasuries.

Valuations are $1.30 per security, $2.60 per CMO, or $12 per limited partnership. There is a one-time set up charge for $150, and $50 for each additional account.

Pensworth
1-800-694-7624
803-699-8080 fax
10120 Two Notch Road 2-123
Columbia, SC 29229
www.Janeschuck.com

EZ Bond calculates the value and accrued interest on EE, E and S series US savings bonds.

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