PREPARING AND FILING THE FORM 706:

Who, What, How, When and Where

By:

GLEN A. YALE

"Nothing in life is to be feared. It is only to be understood."

Madame Curie prior to Internal Revenue Code of 1986

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Glen A. Yale, a member of the Private Wealth Services Section of Holland & Knight, represents high net worth individuals in estate planning, trusts and estates, probate litigation, charitable planning including private foundations, tax-exempt organizations, and marital property law matters. He is board certified in estate planning and probate law by the Texas Board of Legal Specialization.

Previous to joining Holland & Knight as Senior Counsel, Mr. Yale was a shareholder in a San Antonio law firm where he practiced for nearly 22 years in the same areas of the law he currently practices. Prior to entering private practice, Mr. Yale served as a Captain in the U.S. Army Judge Advocate General's Corps.

Mr. Yale has advised high net worth individuals as well as those with more modest estates on the federal estate and income tax aspects of their estate planning as well as the important family considerations of whom will receive the property and in what form, outright or in trust. He has written extensively on preparing the Form 706, U.S. Estate Tax Return, and presented professional programs locally, state-wide, and nationally through Notre Dame Tax Institute and the University of Miami School of Law Heckerling Estate Planning Institute, the two largest professional estate planning programs in the country. Mr. Yale represents executors and trustees in administering estates and trusts, and in other estates he represents beneficiaries in enforcing their full rights to property in the estate or trust.

As lead probate counsel in contested temporary administrations, guardianships, estate administrations, and will contests involving combined estates in excess of $500 million in value, Mr. Yale has litigated issues of testamentary capacity, fiduciary responsibility, marital property, undue influence, and will interpretation among others.

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Mr. Yale has advised individuals and organizations on their legal responsibilities and potential liabilities arising from the activities of nonprofit organizations in Texas and has written *Am I Liable? Responsibilities and Liabilities in Texas Nonprofit Organizations (3rd Edition).* He has advised tax exempt organizations in reorganizations such as mergers, and advised organizations such as nursing homes in separating activities that may give rise to liability from their assets and he has advised existing organizations contemplating creation of endowment funds how to protect newly raised funds from future liability. He has also advised on employee theft, governmental investigations, donor intent, federal income taxation and state franchise taxation, among other issues.

Mr. Yale advises on Texas marital property law, prepares both pre-marital and post-marital property agreements, and advises on marital property issues upon termination of marriage by death. He is also sought out for advise on marital property as it relates to asset protection.

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1 GENERAL MATTERS

§1.01 *Importance of proper preparation*

For most individuals, death is their single most important financial transaction. For the estates of wealthy decedents, the preparation of the Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return, may be the single most important item in estate administration. The Form 706 will determine the taxes paid, the basis of assets, the income taxes paid by the estate and future tax consequences.

The Federal estate tax is a transfer tax.

> The Federal estate tax is neither a property tax nor an inheritance tax. It is a tax imposed upon the transfer of the entire taxable estate and not upon any particular legacy, devise, or distributive share. Escheat of a decedent's property to the State for lack of heirs is a transfer which causes the property to be included in the decedent's gross estate.
>
> Treas. Reg. §20.0-2

The Federal estate tax, along with the Federal gift tax and generation-skipping transfer tax, makes up the Federal transfer tax system. Like the Federal income tax system, the Federal transfer tax system is based on voluntary compliance by taxpayers. The initial statements as to the assets of the estate, the permitted deductions, and even the tax due comes from the taxpayer. Every transfer tax return is subject to some sort of review by the IRS, but, if there is no rigorous examination of the return in whole or in part, the representations of the taxpayer as to the assets and deductions will be the sole determinants of the tax paid. What is the legal, what is the moral, obligation of the taxpayer and the preparer in the representations made on the return to the IRS? The moral obligation is no greater than the legal obligation as can be seen from Judge Learned Hand's famous quote.

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.
>
> *Comm. v. Newman*, 159 F.2d 848, 850-51 (1947)

The preparer has not properly performed the preparer's job when assets that need not be included in the estate are included, when deductions that could be taken are left off the return, when higher values than necessary are placed on assets in a taxable estate, or when the return contains information that may alert the IRS to audit or to assess a higher tax when that information need not be reported. Voluntary compliance is just that -- compliance with the law, regulations and IRS guidance -- it is not self-flagellation or financial suicide.

There is a positive benefit in preparing a return in good faith with all of the required disclosures. After the return is filed, and if there is no audit by the IRS or claim for refund by the taxpayer pending, subsequently discovered facts or assets resulting in higher tax liability need not be disclosed to the IRS. This is more extensively discussed below.

§1.02 *The issues involved*

Virtually every issue in preparing the Form 706 can be classified under one of five general issues.

To properly prepare an estate tax return, the preparer must address all of these general issues and bring all of his or her knowledge to the preparation of the return. Too often, a preparer limits the considerations to includability and misses the tax benefits to the estate when the other issues are addressed.

Estate tax law is not static and the preparer must review advance sheets and the literature to be knowledgeable of new developments.

Even a qualified preparer should have his or her completed return reviewed by other qualified preparers. Despite nearly twenty years' experience in preparing estate tax returns, combined with study and writing this work, your author always has a return he prepares reviewed by a law partner knowledgeable in estate tax matters.

[A] Reporting

Does something need to be reported on the return, even though not included in the gross estate? If required to be reported, how must it be reported?

1. Reporting. *Does something need to be reported on the return, even though not included in the gross estate? If required to be reported, how must it be reported?*

2. Includability. *Is the item included in the gross estate and subject to tax?*

3. Deductibility. *May an item be deducted as an expense or a debt or is it qualified for the marital or charitable deduction?*

4. Valuation. *For an item included in the gross estate, what is the fair market value?*

5. Elections. *Which one among several methods will be chosen to handle the reporting, includability, deductibility, or valuation of an item?*

For example, annual exclusion gifts by decedent need not be reported and are not included in the gross estate, but life insurance on decedent's life and

on which decedent owned no incidents of ownership needs to be reported, even though not included in the gross estate.

Specific types of assets that are required to be reported on a particular schedule, usually have specific reporting requirements imposed by regulations, revenue rulings, instructions, or even the form itself.

[B] Includability

Is the item included in the gross estate and subject to tax?

This necessary inquiry is many times ignored or too readily answered in the affirmative, when a healthy dose of skepticism and research may show that the decedent did not own the asset or had a partial interest rather than the whole. These are ownership issues. Some inquiries will not focus on ownership but rather whether the item is nevertheless included or not included in the federal gross estate, called in this work "inclusion issues."

[1] Ownership issues

If the decedent was not the owner, then that is a good indication that it is not included in the federal gross estate. Several recent cases illustrate this basic principle.

In *Frazier v. Comm.*, 2001 WL 470029 (9th Cir. 2001) (unpublished disposition); 87 AFTR2d 2001 - 2216, the decedent during life leased land to a closely held business in which decedent had a partial ownership interest. The company made improvements and retained in its lease the right to remove trade fixtures. The company held over and occupied the property on decedent's death. The estate excluded the improvements and the appeals court remanded to the tax court for a determination if the improvements were trade fixtures that the tenant could remove and if so, then the improvements could be excluded. See, §4.05 Valuation, Chapter 5, "Schedule A, Real Estate," for a further discussion of this case.

The value of fractional undivided interests in two parcels of real property held by a QTIP trust and includable in the decedent's gross estate under IRC § 2044 did not include any beneficial interest in timber and pecan orchards located on the property because the beneficial interest in the timber and pecan orchards remained with the donor of the QTIP interest. *Estate of Augusta P. Forbes v. Comm.*, TC Memo 2001-72 (2001).

Not every attempt to avoid inclusion will be successful. In *Estate of Theodore C. Chemodurow*, TC Memo 2001-14, the Tax Court held that ranchland and equipment were includable in the decedent's gross estate because the doctrine of collateral estoppel precluded the estate from claiming that the decedent had sold the property prior to his death. The decedent's daughter, also the executrix, had unsuccessfully attempted in state court to quiet her title to ranchland and equipment. The IRS successfully argued that the state court decisions collaterally estopped the daughter from raising the issues because of the application of collateral estoppel requirements set forth in D. Peck, 90 TC 162, (i) the issues raised in the second suit were identical to the issues decided in the first suit, (ii) a final judgment was rendered by a court in the first suit, (iii) the petitioner in the second suit was a party to the prior judgment, (iv) the issues were litigated and the resolution of the issues was essential to the result in the first suit, and (v) the controlling facts and applicable legal rules remained unchanged from those in prior litigation.

[2] Inclusion issues

There are a host of inclusion issues that need to be addressed by the preparer. Some issues involve whether the item is included in the estate, even though the decedent did not technically own the asset. The regulations state, "the gross estate may include property in which the decedent did not have an interest at the time of his death. A decedent's gross estate for Federal estate tax purposes may therefore be very different from the decedent's estate for local probate purposes." Treas. Reg. §20.0-2(b)(2).

See the discussion of life insurance on the decedent's life that may not have been owned by the decedent but is nevertheless included in the estate. Also, joint property may be included in the gross estate and reported on Schedule E although under state law the decedent may not strictly own the property. Moreover, the discussion of what is reported on Schedule G centers on what is not actually owned by the decedent but is nevertheless included in the federal gross estate. On the other hand, see "Name, voice, signature, and likeness" discussion in Chapter 10, "Schedule F, Other Miscellaneous Property," where the estate may include valuable property rights in the decedent's name, voice, signature and likeness, yet no value need be included in the federal gross estate.

[C] Deductibility

May an item be deducted as an expense or a debt or is it qualified for the marital or charitable deduction? IRC § 2051 defines the value of the taxable estate as the gross estate less deductions. Yet, it has en stated, "For estate taxes, as for income taxes, 'Deductions are a matter of legislative grace, and a taxpayer seeking the benefit of a deduction must show that every condition which Congress has seen fit to impose has been fully satisfied.'" *Estate*

of Nicholson v. Comm., 94 TC 666,681-82 (1990). Entitlement to a deduction cannot be assumed.

Not everything that appears to be a deductible item can be deducted. Property taxes assessed after the decedent died cannot be deducted even though they appear to be reasonable expenses of administration. On the other hand, if a decedent died in January before paying property taxes for the prior year, there are two deductions for property taxes: those for the prior year and those for the year of death.

The requirements for obtaining the marital or charitable deduction are extensive and full of technicalities. Where some of the technical requirements are lacking, the preparer may be able through disclaimers or reformations to meet the requirements and obtain a deduction for what would otherwise not be deductible.

[D] Valuation

For an item included in the gross estate, what is the fair market value?

Valuation of an estate asset may not be immediately obvious. The valuation of assets qualifying for the marital deduction may not be as low as reasonably possible because estate taxes will not be increased by higher values, but an increased basis for future avoidance of capital gains taxes may be sought. Yet, a high value on an asset qualifying for the marital deduction may prevent low valuation in the surviving spouse's estate.

Your author hopes that all of this work is of value, but certainly most of this work is about value. Valuation issues are discussed in each of the chapters on the asset schedules, and valuation has its own chapter, Chapter 2, "Valuation."

[E] Elections

Which one among several methods will be chosen to handle the reporting, includability, deductibility or valuation of an item?

Elections include questions on the return that are specifically termed "elections," as well as the various filing choices available.

[1] Return elections

These elections may be items that are listed on Lines 1 to 4, of Part 3 of the return as "elections."

(1) Alternate valuation;

(2) Special use valuation;

(3) Pay taxes in installments as described in Internal Revenue Code (hereafter "IRC") Section 6166; and

(4) Postpone the payment of taxes attributable to a reversionary or remainder interest as described in IRC § 6163.

[2] Reporting as elections

These elections may involve a choice of whether the executor or a beneficiary should do the following. (This list is the author's and is not found directly on the form.)

(1) A qualified disclaimer of an interest so it passes to the spouse and qualifies for the marital deduction, or a qualified disclaimer by the spouse so an interest that qualifies for the marital deduction does not.

(2) Whether property otherwise qualifying for the marital deduction as qualified terminable interest property should be elected for the marital deduction.

(3) Whether administration expenses should be deducted on the Form 706 or on the Form 1041, U.S. Income Tax Return for Estates and Trusts.

(4) Whether to make a qualified disclaimer so property passes to a charitable organization and qualifies for the charitable deduction.

(5) Whether to make a qualified disclaimer so property passes to a generation-skipping transfer (GST) skip person or so property otherwise passing to a GST skip person does not.

(6) Whether a beneficiary of the estate who is serving as an executor should take an executor's fee.

(7) Whether administration expenses should be allocated to principal or to income.

(8) Whether to make the reverse QTIP election for GST purposes.

(9) Whether to make a QDOT election on property that otherwise would qualify for the marital deduction.

(10) How to allocate the decedent's remaining GST exemption.

(11) Resolution of ownership of property.

[3] Additional information

McPherson, Yussman, and Filcik, "Postmortem Strategies that Enhance a Client's Estate Plan," *Estate Planning*, Mar., Apr., 1995 at 91.

[F] Other resources

Despite the importance of preparing the estate tax return, there are few resources on preparation of the return and reporting assets.

Lawrence M. Bass, *The Estate Tax Controversy-Preparation of the Estate Tax Return and Beyond*, 19TH ANN. TEXAS ADV. EST. PLANN. AND PROB. COURSE, June 1995.

Frank S. Berall, *Preparing the 706*, National Law Foundation (1998).

George M. Schain, *Estate, Gift, Trust, and Fiduciary Tax Returns*, WEST GROUP (2001).
706/709 Deskbook, Practitioners Publishing Company.

§1.03 *Executor files*

"The executor shall carefully prepare the return, ... so as to set forth fully and clearly the data called for therein." Treas. Reg. §20.6011-1(b). The term "executor" means the executor or administrator of the decedent. If there is no executor or administrator appointed, qualified and acting within the U.S. then the executor means any person in actual or constructive possession of any property of the decedent. IRC § 2203. Where the decedent's property avoids probate by means of a revocable trust, the trustee of the trust will assume the role of executor for purposes of filing the estate tax return.

[A] Signature

All executors must verify and sign the return and are liable for penalties provided for erroneous, false or fraudulent returns. IRC § 6061; Treas. Reg. §20.6061-1; Instructions, p.2. The return and any declaration, statement, or other document required must be signed under penalties of perjury. IRC § 6065. The fact that an individual's name is signed to a return is prima facie evidence for all purposes that the return was actually signed by that person. IRC § 6064. The burden of proof is on anyone who challenges the genuineness of a signature.

[B] More than one executor

The executors should join in filing one complete return. Treas. Reg. §20.6018-2. If the executors are unable to join in making one complete return, each executor should file a return disclosing all information that executor has, including the name and address of every person holding property. Instructions, p. 2.

Consider this caution in the Instructions. p. 2:

> If there is more than one executor, all listed executors are responsible for the return. However, it is sufficient for only one of the co-executors to sign the return.

[C] Notice to but one executor

In *Estate of McElroy v. Comm.*, 82 TC 509 (1984), the notice of deficiency mailed to the first of three co-executors listed on the estate tax return was held by the tax court to be sufficient notice since all three co-executors were qualified under state law to receive notice and the notice was actually received. To the same effect was *Estate of E. M. Kisling v. Comm.*, 32 F.3d 1222, 1226 (8th Cir. 1994), where by providing a notice of an estate tax deficiency to one of the three personal representatives of a decedent's estate, the IRS gave the estate sufficient notice of any estimated tax deficiency and of the necessity of a response.

[D] Persons in possession

As stated above, any person in actual or constructive possession of any property of decedent is treated as the executor and obligated to file the estate tax return if there is no actual executor or administrator appointed, qualified and acting within the United States. IRC § 2203. The Instructions, p.2, placed a twist on the statutory definition in providing,

> If the appointed, qualified, and acting executor is unable to make a complete return, then every person holding an interest in the property must, on notice from the IRS, make a return regarding that interest.

In *U.S. v. DeNiro*, 392 F.2d 753 (6th Cir. 1968), three brothers of the decedent who had improperly taken custody of the decedent's estate were convicted of tax evasion of federal estate taxes and their willfulness to evade taxes was shown by the fact that the IRS agent had notified them that estate taxes were due on their brother's estate.

§1.04 *Preparer-client relationship*

> Any individual may prepare a tax return.
>
> Treas. Circular 230 § 10.7(e).

[A] Tax return preparation and practice of law

The definition of the "practice of law" as set forth in Tex. Gov. Code §81.101(a) encompasses the giving of advice that is inherent in preparing an estate tax return.

> In this chapter the "practice of law" means the preparation of a pleading or other document incident to an action or special proceeding or the management of the action or proceeding on behalf of a client before a judge in court as well as a service rendered out of court, including the giving of advice or the rendering of any service requiring the use of legal skill or knowledge, such as preparing a will, contract, or other instrument, the legal effect of which under the facts and conclusions involved must be carefully determined. (Emphasis added.)

There are two Texas attorney generals' opinions to the effect that tax return preparation is the practice of law. Op.Atty.Gen. 1943, No. O-5086 (service rendered by a layman, whether an accountant or not, in advising and assisting public in preparing income tax returns is in violation of the practice of law act) and Op. Atty. Gen. 1967, No. M-150 (corporate purpose clause providing for the preparation or assistance in the preparation of federal and state income tax returns would necessarily include the

practice of law). The above are primarily cited as being quaint, because any state effort to make tax return preparation the practice of law is pre-empted by Treasury Circular 230 when it states as quoted above, "Any person may prepare a tax return." Advice as an integral part of preparing a tax return is supported by the text of Treas. Reg. §301.7701-15(a)(2). When defining income tax return preparer it excepts a person who only gives advice on specific issues of law, unless the advice is given with respect to events that have occurred at the time the advice is rendered or the advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. Advice regarding the existence, characterization or amount of entry on a return is an inherent part of preparing a tax return and permitting anyone to prepare a return of necessity carries with it permitting anyone to give advice regarding the existence, characterization or amount of entry on a return. It is difficult to separate giving tax advice on the entry to be made on an estate tax return for real property from giving legal advice when a major issue that may need to be resolved is what interest the decedent had in the real property. With any item of property to be listed on the estate tax return, a necessary question that must be answered is what interest the decedent owned. Also, preparation of an estate tax return may require interpretation of a will, but such matters are frequently handled by non-lawyers. The presence of significant legal issues may mean that an attorney is more competent to resolve those issues, but the presence of substantial legal issues could mean that the non-lawyer preparer is not sufficiently competent to complete the return without bringing in an attorney for legal advice. Matters in preparing an estate tax return that clearly are the practice of law would include preparation of legal documents such as inventories, disclaimers, reformation petitions, and family settlement agreements.

[B] Attorney-client privilege

Questions of the attorney-client privilege in federal income tax investigations are matters of federal law. *Colton v. United States*, 306 F.2d 633 (2nd Cir. 1962) *cert denied,* 371 US 951, 83 S.Ct. 505 (1963); *Falsone v. United States*, 205 F.2d 734 (5th Cir. 1953), *cert. denied* 346 U.S. 864, 74 S.Ct. 103, 98 L.Ed. 375 (1953); *In re Albert Lindley Lee Memorial Hospital*, 209 F.2d 122 (2nd Cir. 1953), *cert. denied*, 347 U.S. 960, 74 S.Ct. 709, 98 L.Ed. 1104 (1954). Nothing would suggest that federal estate tax questions too are not matters of federal law.

In *Colton, Id.* at 637, with regard to preparing tax returns, the court stated that the attorney-client privilege could attach:

> There can, of course, be no question that the giving of tax advice and the preparation of tax returns...are basically matters sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege.
>
> For the privilege to attach:
>
> (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.
>
> *United States v. United Shoe Mach. Corp*., 89 F. Supp. 357, 358-59 (D. Mass. 1950), quoted with approval *Colton v. United States, Id*. at 637.

The court in *Colton* specifically addressed the limitations on the privilege when the representation is preparing a tax return.

> Not all communications between an attorney and his client are privileged. Particularly in the case of an attorney preparing a tax return ... a good deal of information transmitted to an attorney by a client is not intended to be confidential, but rather is given for transmittal by the attorney to others – for example, for inclusion in the tax return. Such information is, of course, not privileged.

Id. at 638.

Who the attorney represented, the nature of the representation and the dates of the representation would not be privileged. The privilege attaches to papers prepared by the client for the purpose of confidential communication to the attorney or by the attorney to record confidential communications. *Id.* at 639. As for pre-existing documents and financial records not prepared by the client for the purpose of communicating with their lawyers in confidence they are privileged only if the client could have refused to produce such papers that the attorney may do so when they have passed into his possession. *Id*. Statements, correspondence and documents received from third parties are not privileged, and would not come under the work product rule because it could not be shown that such statements, correspondence and documents were collected or prepared in anticipation of litigation. *Id.* at 639-40. Copies of tax returns in the attorney's files would not be privileged

as confidential because by definition they contain no information that was not intended to be given to the IRS. *Id.* at 640. The positive things said in *Colton* regarding privileged documents belies the fact that the court found nothing to be privileged.

It may be that the work product rule is broader than the court said in *Colton*. In *Upjohn Company v. U.S.* 449 U.S. 383 (1981), the Court states that the government wisely conceded that the work product doctrine applies to IRS summonses. At issue were statements made to the company's general counsel regarding improper payments to foreign government officials that the IRS sought to determine compliance with the income tax laws. "Forcing an attorney to disclose notes and memoranda of witnesses' oral statements is particularly disfavored because it tends to reveal the attorney's mental processes." *Id.* at 399. "The privilege only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney." *Id.* at 395.

There is case law that supports the proposition that the preparation of tax returns is primarily an accounting function and not a legal function. *In Re Grand Jury Investigation*, 842 F.2d 1223, 1225 (11th Cir. 1987) (attorney-client privilege attaches only to communications made in confidence to an attorney by that attorney's client for the purpose of receiving legal advice or assistance; any information that taxpayer transmitted to attorney for purpose of preparation of his tax returns, including sources of his income, did not fall under attorney-client privilege; individual income tax return). *U.S. v. El Paso Co.* 682 F.2d 530, 539 (5th Cir. 1982)(preparation of tax returns is generally not legal advice within the scope of attorney-client privilege; corporate tax returns). *U.S. v. Davis*, 636 F.2d 1028, 1043-44 (5th Cir. 1981), *cert. denied* 454 U.S. 862. In *Huie v. DeShazo*, 922 S.W.2d 920, 927 (Tex. 1996), the Texas Supreme Court appeared to approve the contention of one of the parties that the attorney-client privilege does not apply when an attorney is employed to prepare tax returns, as the attorney is primarily performing accounting rather than legal services. The above cited federal cases dealt with income tax returns and not estate tax returns. Arguably, the five general issues above involve legal issues such that the attorney- client privilege should attach to preparation of an estate tax return. That was the holding in *U.S. v. Lawless*, 709 F.2d 485 (7th Cir. 1983), in a case involving documents handed to an attorney to prepare an estate tax return the Court found that information transmitted for the purpose of preparation of a tax return, though transmitted to an attorney, is not privileged information. Transmission of information so that it can be used on an estate tax return destroys any expectation of privacy.

Attached as Appendix A is a sample memorandum illustrating that the preparation and filing of an estate tax return typically involves the resolution of what appears to be significant legal issues. Yet, if one need not be an attorney to prepare the returns, then these cannot truly be legal issues.

[C] Accountant-client privilege

The Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, provides that in any noncriminal tax matter before the IRS and any noncriminal tax proceeding in federal court by or against the United States, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent that communication would be considered a privileged communication if it were between a taxpayer and an attorney. IRC § 7525(a)(1). This privilege being the same as the attorney-client privilege, it should not apply generally to tax return preparation.

Couch v. U.S., 409 U.S. 322, 93 S.Ct. 61 (1973), found no accountant-client privilege. The taxpayer hired an independent accountant to whom she had delivered regularly over a period of years various business and tax records that remained in the accountant's continuous possession. The taxpayer's divestment of possession of such records removed her entitlement to invoke a Fourth or Fifth Amendment privilege to prevent the production of her business and tax records in possession of the accountant.

> Petitioner further argues that the confidential nature of the accountant-client relationship and her resulting expectation of privacy in delivering the records protect her, under the Fourth and Fifth Amendments, from their production. Although not in itself controlling, we note that no confidential accountant-client privilege exists under federal law, and no state created privilege has been recognized in federal cases. [citations omitted]. . . . [T]here can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return. What information is not disclosed is largely in the accountant's discretion, not petitioner's. Indeed, the accountant himself risks criminal prosecution if he willfully assists in the preparation of a false return. 26 U.S.C. §7206(2). His own need for self-protection would often require the right to disclose the information given him. Petitioner seeks extensions of constitutional protections

against self-incrimination in the very situation where obligations of disclosure exist . . .

Also devastating to a claim of privilege was *U.S. v. Arthur Young & Company*, 465 U.S. 805, 104 S.Ct. 1495 (1984), where the Supreme Court found no work-product immunity for tax accrual work papers prepared by independent accountant and summoned by the IRS.

There is little left to the privilege for attorneys or accountants after the Seventh Circuit opinion of *U.S. v. Frederick*, 182 F.3d 496 (7th Cir. 1999), when summonses were issued to the lawyer-accountant for taxpayers, the court held that documents created by the lawyer-accountant in connection with preparation of clients' tax returns and audits were not within the attorney-client or work-product privilege, and a dual-purpose document prepared for use in preparing tax returns and for use in litigation is not privileged.

> Most of the documents in issue were created in connection with [lawyer-accountant]'s preparation of the [taxpayer]s' tax returns. They are drafts of the returns (including schedules), worksheets containing the financial data and computations required to fill in the returns, and correspondence relating to the returns. These are the kinds of document that accountants and other preparers generate as an incident to preparing their clients' returns, or that the taxpayers themselves generate if they prepare their own returns, though in the latter case there is unlikely to be correspondence. . . .
>
> There is no common law accountant's or tax preparer's privilege, *Couch v. United States*, 409 U.S. 322, 335, 93 S.Ct. 611, 34 L.Ed.2d 548 (1973); *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-19, 104 S.Ct. 1495, 79 L.Ed.2d 826 (1984), and a taxpayer must not be allowed, by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself or herself, normally would do, to obtain greater protection from government investigators than a taxpayer who did not use a lawyer as his tax preparer would be entitled to. *United States v. Lawless*, 709 F.2d 485, 487-88 (7th Cir. 1983); *United States v. Bornstein*, 977 F.2d 112, 116-17 (4th Cir. 1992); *In re Grand Jury Investigation*, 842 F.2d 1223, 1224-25 (11th Cir. 1987); *United States v. Davis*, 636 F.2d 1028, 1043 (5th Cir. 1981). To rule otherwise would be to impede tax investigations, reward lawyers for doing nonlawyers' work, and create a privileged position for lawyers in competition with other tax preparers--and to do all this without promoting the legitimate aims of the attorney-client and work-product privileges. The attorney-client privilege is intended to encourage people who find themselves involved in actual or potential legal disputes to be candid with any lawyer they retain to advise them. *Upjohn Co. v. United States*, 449 U.S. 383, 389, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). The hope is that this will assist the lawyer in giving the client good advice (which may head off litigation, bring the client's conduct into conformity with law, or dispel legal concerns that are causing the client unnecessary anxiety or inhibiting him from engaging in lawful, socially productive activity) and will also avoid the disruption of the lawyer-client relationship that is brought about when a lawyer is sought to be used as a witness against his client. The work-product privilege is intended to prevent a litigant from taking a free ride on the research and thinking of his opponent's lawyer and to avoid the resulting deterrent to a lawyer's committing his thoughts to paper. *United States v. Nobles*, 422 U.S. 225, 236-39, 95 S.Ct. 2160, 45 L.Ed.2d 141 (1975); *Hickman v. Taylor*, 329 U.S. 495, 510-11, 67 S.Ct. 385, 91 L.Ed. 451 (1947); *Id.* at 516, 67 S.Ct. 385 (Jackson, J., concurring).
>
> Communications from a client that neither reflect the lawyer's thinking nor are made for the purpose of eliciting the lawyer's professional advice or other legal assistance are not privileged. The information that a person furnishes the preparer of his tax return is furnished for the purpose of enabling the preparation of the return, not the preparation of a brief or an opinion letter. Such information therefore is not privileged.
>
> We do not, however, accept the government's argument that there is no issue of privilege here because the information was transmitted to a tax preparer with the expectation of its being relayed to a third party, namely the IRS. It is true that "if the client transmitted the information so that it might be used on the tax return, such a transmission destroys any expectation of confidentiality." *United States v. Lawless, supra*, 709 F.2d at 487; *see also United States v. Windfelder*, 790 F.2d 576, 579 (7th Cir. 1986); *In re Grand Jury Proceedings*, 727 F.2d 1352, 1356 (4th Cir. 1984). That is, the transmittal operates as a waiver of the privilege. But the tax preparer here was also the taxpayers' lawyer, and it cannot be assumed that everything transmitted to him by the taxpayer was intended to assist him in his tax-preparation function and thus might be conveyed to the IRS, rather than in his legal-representation function. Cf. *United States v. (Under Seal)*, 748 F.2d 871, 875-76 (4th Cir. 1984).
>
> We also reject the government's argument that numerical information can never fall within the attorney-client or work-product privilege. Cf. *United States v. Schwimmer*, 892 F.2d 237, 242 (2d Cir. 1989); *United States v. Davis, supra*, 636 F.2d at 1043; *In re Grand Jury Proceedings*, 601 F.2d 162, 171-72 (5th Cir. 1979). Such cases are rare, but they can be imagined. Suppose a lawyer prepared an estimate of his client's

damages; the estimate would be numerical, but insofar as it reflected the lawyer's professional assessment of what to ask the jury for it would be attorney work product. Similarly, if the lawyer asked his client how much he had obtained in the theft for which he was being prosecuted and the client answered, "$10,000," the answer would be protected by the attorney-client privilege. But we do not agree with the appellants that the district judge based his ruling on the erroneous view that numbers can never be privileged. He found no basis for privileging these numbers, remarking, rightly, "It cannot be argued that numbers in the hands of the accountant are different from numbers in the hands of a lawyer."

Besides the information supplied to [lawyer-accountant] by the [taxpayer]s, there are the worksheets, which [lawyer-accountant] prepared and which doubtless reflect some of his own thinking. But the Supreme Court has held that an accountant's worksheets are not privileged, *United States v. Arthur Young & Co., supra*, 465 U.S. at 817-19, 104 S.Ct. 1495, and a lawyer's privilege, as we explained earlier, is no greater when he is doing accountant's work. A complicating factor is that when [lawyer-accountant] was doing these worksheets and filling out the [taxpayer]s' tax returns, he knew that the IRS was investigating the [taxpayer]s and their company, albeit in connection with different tax years, and he was representing them in that investigation. But people who are under investigation and represented by a lawyer have the same duty as anyone else to file tax returns. They should not be permitted, by using a lawyer in lieu of another form of tax preparer, to obtain greater confidentiality than other taxpayers. By using [lawyer-accountant] as their tax preparer, the [taxpayer]s ran the risk that his legal cogitations born out of his legal representation of them would creep into his worksheets and so become discoverable by the government. The [taxpayer]s undoubtedly benefited from having their lawyer do their returns, but they must take the bad with the good; if his legal thinking infects his worksheets, that does not cast the cloak of privilege over the worksheets; they are still accountants' worksheets, unprotected no matter who prepares them.

Put differently, a dual-purpose document--a document prepared for use in preparing tax returns and for use in litigation--is not privileged; otherwise, people in or contemplating litigation would be able to invoke, in effect, an accountant's privilege, provided that they used their lawyer to fill out their tax returns. And likewise if a taxpayer involved in or contemplating litigation sat down with his lawyer (who was also his tax preparer) to discuss both legal strategy and the preparation of his tax returns, and in the course of the discussion bandied about numbers related to both consultations: the taxpayer could not shield these numbers from the Internal Revenue Service. This would be not because they were numbers, but because, being intended (though that was not the only intention) for use in connection with the preparation of tax returns, they were an unprivileged category of numbers.

The most difficult question presented by this appeal, and one on which we cannot find any precedent, relates to documents, numerical and otherwise, prepared in connection with audits of the taxpayers' returns. An example is a memo from [lawyer-accountant] to a paralegal asking her for the amount that Mr. [taxpayer] and his corporation had paid [lawyer-accountant] for legal services rendered personally to [taxpayer] in 1992. The memo was prepared to help [lawyer-accountant] respond to questions raised in an audit of the [taxpayer]s' and the corporation's tax returns. An audit is both a stage in the determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation. When a revenue agent is merely verifying the accuracy of a return, often with the assistance of the taxpayer's accountant, this is accountants' work and it remains such even if the person rendering the assistance is a lawyer rather than an accountant. Throwing the cloak of privilege over this type of audit-related work of the taxpayer's representative would create an accountant's privilege usable only by lawyers. If, however, the taxpayer is accompanied to the audit by a lawyer who is there to deal with issues of statutory interpretation or case law that the revenue agent may have raised in connection with his examination of the taxpayer's return, the lawyer is doing lawyer's work and the attorney-client privilege may attach. But the documents in issue do not, so far as we are able to determine, relate to such representation.

In reading the above, one would think one was reading a pre-IRC § 7525 case. That is not the case.

We should consider the possible bearing of a new statute, 26 U.S.C. § 7525, which extends the attorney-client privilege to "a federally authorized tax practitioner," that is, a nonlawyer who is nevertheless authorized to practice before the Internal Revenue Service. § 7525(a)(3)(A). Nonlawyers (including tax preparers, many of them accountants) have long been allowed to practice before it. 5 U.S.C. § 500(c); 31 C.F.R. §§ 10.3, 10.7(c)(viii). The new statute protects communications between a taxpayer and a federally authorized tax practitioner "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." § 7525(a)(1). (It does not protect work product.) Nothing in the new statute suggests that these nonlawyer practitioners are entitled to privilege when they

are doing other than lawyers' work; and so the statute would not change our analysis even if it were applicable to this case, which it is not, because it is applicable only to communications made on or after July 22, 1998, the date the statute was enacted. See Note following 26 U.S.C. § 7525.

Because this case was decided as if IRC § 7525 was added, after attorneys and accountants got the same privilege, the failure to find the privilege for an attorney makes the loss of confidentiality even greater.

[D] What's left of the privilege?

The above discussion would indicate that there is nothing left of the privilege, and there were no reported cases in which the privilege was recognized as to particular documents or testimony until *Bria v. U.S.*, 2002 TNT 78-13 (D. Conn. 2002). *Bria* retained attorneys to handle legal matters arising from her mother's death including preparing an estate tax return, but *Bria* terminated the attorneys before the return was filed. The IRS issued summons to the attorneys for information so the IRS could determine if *Bria* undervalued the estate on the return that was filed. The attorneys released some documents but on behalf of *Bria* invoked the attorney-client privilege for some documents and testimony. The court briefly discussed the applicable law and ruled some items privileged and some not depending upon whether they were transmitted to the attorneys for legal work or preparation of the estate tax return. Privileged testimony included: (1) any advice that taxpayer requested about how joint bank accounts are treated; (2) communications regarding the value of a mortgage; (3) conversations about how to handle the mortgage after speaking with the person who valued the mortgage; (4) attorney's determination of the value of a mortgage when question was asked in the specific context of the probate inventory; (5) taxpayer's reaction to the draft Form 706; (6) taxpayer's understanding of whether the asset would be included in the tax return; (7) taxpayer's statements about the value of the property with respect to the note and whether it was uncollectible; (8) whether the attorney communicated to taxpayer that the mortgage would be worthless; and (9) why the taxpayer terminated the attorneys and the nature of the fee dispute that was involved. Documents privileged included communications containing tax advice not related to preparing the Form 706. Not privileged testimony included: (1) communications regarding contributions to joint bank accounts; (2) attorney's basis for preparing a draft return listing $405,000 in bank accounts; (3) attorney's initial determination of whether the joint bank accounts should be included as an asset of the decedent on the draft estate tax return; (4) what taxpayer may have said about the value of the property with respect to the amount of the note; and (5) how the value of the mortgage for the draft Form 706 was communicated to the taxpayer. Documents not privileged included the attorney's memorandum to file of information gathered from discussion with third parties and the attorney's "to do" list.

[E] Engagement letter

Preparing a Form 706, an important joint endeavor by the preparer, should be the subject of an engagement letter between the preparer and the executor (or whoever has the obligation to file) addressing each of the items in Checklist 1, Attorney Engagement Letter Checklist. An engagement letter becomes particularly important when an attorney serves as the preparer, as will become clear from this discussion. This important first step requires careful consideration at the start of the representation. Attached as Appendix B is a sample engagement letter.

[1] Whom the attorney represents

In preparing a Form 706, the client will usually be the executor. The letter should also include a statement as to whom the attorney does not represent, when a reasonable or even unreasonable but coherent person might think the attorney does represent that person, such as the surviving spouse or the beneficiaries. An unwise preparer represents the executor as well as the beneficiaries. Such a preparer, as a practical matter, becomes the guarantor of a good result for all involved, even if that requires the preparer to put up his or her own funds. Even if adverse financial consequences do not occur, the preparer may be placed in the role of referee with the enmity of all parties the earned result. If persons with an interest in the estate attend any of the initial conferences with the executor, the attorney should consider sending that person a non-engagement letter stating that the attorney only represents the executor, that the attorney does not represent that person and that the person may wish to obtain his or her own attorney.

[2] Conflicts language

If representing two or more clients, then conflicts language should be included regarding what happens if there is a disagreement as to any aspect of the representation and the confidentiality of client provided information.

Even if representing one client, conflicts may arise and the engagement letter should address that possibility. If the attorney has, presently or in the past, an attorney-client relationship with a beneficiary, heir or creditor of the estate, that the attorney believes will not adversely affect the

Checklist 1 Attorney Engagement Letter Checklist
❑ Whom the attorney represents, usually the executor. ❑ General conflicts of interest language when representing one client. ❑ Detailed conflicts of interest language when representing more than one client. ❑ Waiver of conflicts by attorney. ❑ Confidentiality of information. ❑ The scope of the engagement: what the attorney is engaged to do and what the attorney is not engaged to do. ❑ The financial terms of the engagement. ❑ How engagement may be terminated. ❑ Privacy notice. ❑ Disclosures required by state law: ❑ Texas Lawyers' Creed (or other state requirements) ❑ How to report professional misconduct. ❑ Interest charged on unpaid invoices. ❑ Arbitration.

representation of the executor, the attorney must make disclosure and seek the informed consent of the executor and the beneficiary, heir or creditor. Of course, if the prior representation will adversely affect the representation, the attorney should decline the representation to represent the executor. If the attorney has a claim against the estate for prior services representing the decedent, the attorney should make disclosure to the executor and seek waiver.

A conflict of interest may arise with the client in the client's capacity as executor and the client's capacity as a beneficiary or as surviving spouse. Clearly the executor as a fiduciary owes fiduciary duties to the persons interested in the estate: the surviving spouse, beneficiaries, heirs and creditors.[*] When the executor has a conflict of interest, whether the attorney represents the executor in both capacities, is handled differently by capable attorneys. Some attorneys see no problem in representing the executor in both capacities, making certain that the executor is advised to make full disclosure to all other interested persons. Other attorneys find it preferable to represent the executor solely in his or her capacity as executor and advise the executor that he or she must seek other counsel for representation in the other capacity.[**] In the former practice, the executor should be advised to inform the attorney of any such conflicts and say the attorney will attempt to advise the client how to handle the conflicting interests. If the attorney cannot help the client resolve the conflicts, it may ultimately be necessary for the attorney to follow the later practice.

[3] Scope of the engagement

Aspects of the scope of the engagement include a clear statement of what services the preparer will perform and what services will not be performed but the client could reasonably think are included in the representation.

The attorney cannot, by agreement, decrease the standard of care owed the client, such as by saying that the attorney will be responsible for gross negligence but not simple negligence. Disciplinary Rule 1.08(g); Model Rule 1.8(h). But the engagement letter can set forth the specific legal matters covered by the representation, such as preparing the estate tax return but not defending the validity of the will. Disciplinary Rule 1.02(b) permits an attorney to limit the scope, objections and general methods of the representation if the client consents after consultation. Model Rule 1.2(c), "A lawyer may limit the objectives of the representation if the client consents after consultation," is similar.

The sample engagement letter includes language excluding any legal representation "to provide business or investment advice, bookkeeping services, safekeeping of assets, or income tax return preparation." Accountant preparers may wish to exclude financial planning. Whether or not the preparer will also prepare income tax returns, in preparing the estate tax return, the preparer may come into possession of income tax returns prepared by another and the engagement should explicitly exclude responsibility to review an income tax return prepared by another. Such exclusion of responsibility will help the preparer avoid financial responsibility for potential refunds lost due to the passing of the statute of limitations. Because the executor may claim reliance that the preparer reviewed every document passing through the preparer's hands, attorneys in particular should consider adding this limiting language:

> In the course of preparing the Form 706, we will use or refer to documents prepared by others, including but not limited to, deeds, legal descriptions of real property, agreements, registrations, financial statements, tax returns, bank statements and certificates. Even though we may use information contained in such documents prepared by others or use the documents themselves, you should not take such use to be an opinion as to the accuracy or legal effectiveness of such documents. If you want us to review and be responsible for the accuracy and legal effectiveness of documents prepared by others, then that needs to be included in a new written engagement letter. Under our current

[*] This listing of interested persons to whom the executor owes duties is taken from Tex. Prob. Code §3(r) but is similar to common rules of other states.

[**] A corporate executor may also have a conflict if serving as trustee of a trust distributee when there are other interested parties.

> engagement, our firm is not engaged to review for the general accuracy of, nor is it responsible for the legal effectiveness of, documents prepared by others.

Model Rule 1.1, entitled "Competence," states,

> A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

While this quoted statement applies only to attorneys, certainly no one should undertake to prepare an estate tax return without the knowledge, skill and preparation reasonably necessary for the task. Reading this article will be a major step in giving you that knowledge, skill and preparation. The ACTEC Commentaries contain this case description in which an attorney and an accountant were subject to a malpractice claim for what could generally be described as lack of competence.

> *Kinney v. Shinholser*, 663 So.2d 643 (Fla. App. 1995). Applying Florida malpractice standards, the court here upheld the dismissal of a complaint against the lawyer who drew a will for a married client which did not preserve the tax benefit of the testator's unified credit. The will gave the testator's entire residuary estate to a trust for the benefit of his widow, over which she was given a general power of appointment. In effect, the will caused the widow's estate to pay some estate tax that was avoidable had she not been given a general power of appointment. According to the court there was no evidence of malpractice by the scrivener as the will did not indicate any intent to minimize taxes on the death of the surviving spouse. However, the court held that the complaint stated a cause of action by the decedent's son, the remainderman under the husband's will and the sole beneficiary of the wife's will, against the lawyer and the accountant who were retained by the surviving spouse to probate the will and prepare the federal estate tax return for failing to advise her of the tax savings that would be achieved if she disclaimed the general power of appointment.

Experience is learning from your own mistakes while knowledge is learning from the mistakes of others. Here is another case description from the ACTEC Commentaries:

> *Schmitz v. Crotty*, 528 N.W.2d 112 (Iowa 1995). In this legal malpractice action the Supreme Court of Iowa found that an attorney retained to handle a decedent's estate had breached the duty of care he owed to the estate beneficiaries in negligently completing the estate's death tax returns and failing to recognize that the same parcel of land included on the return was being described three times and that some of the land included on the returns was subject to a life estate. The attorney also failed to thoroughly investigate and make reasonable efforts to verify the legal descriptions of the land set forth in the death tax returns after he was told that there was an error in the descriptions.

The ACTEC Commentaries to Model Rule 1.1 recognize the importance of the client giving the lawyer complete and accurate information and the lawyer needs to inform the client. This paragraph is from the sample engagement letter at Appendix B.

> You are required to sign the Form 706, which contains a statement saying "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." While we will sign the return as preparers, in preparing the Form 706, we of necessity must rely on the information you provide to us. Thus, it is your responsibility to make sure the information contained on the Form 706 is complete and accurate to the best of your knowledge.

Once a lawyer has advised a client of the client's responsibility to provide the necessary information, then the lawyer can generally rely on information provided by the client "unless the circumstances indicate that the information should be verified." Commentary to Model Rule 1.1.

The representation must relate to the clients. For example, the representation cannot include representing the surviving spouse on marital property rights if the surviving spouse is not the client. Nor should the representation include tax advice for the beneficiaries unless the executors are also the beneficiaries.

The representation must relate to the fee. If giving a fixed fee, the fee must cover the entire representation. Also, it will be difficult if not impossible to charge even an hourly fee for items not a part of the representation.

[4] Related tasks

Related tasks that could be part of the representation, but are not, should be identified and if known who is responsible for that task that person and task should be identified. For example, if probating the will is performed by another attorney, or the decedent's final income tax return or the estate's fiduciary income tax returns are to be prepared by another, clearly note that is not covered by your engagement letter.

[5] The financial terms of the engagement

> The avoidance of taxes is the only intellectual pursuit that carries any reward.
>
> John Maynard Keyes

This may be the most difficult part of the letter to place into words because the exact legal services to be provided may not be entirely apparent.

The fee charged must be hourly, a flat fee, or a percentage of the overall estate, but cannot be a contingent fee for preparing the original return. Treas. Circular 230 provides:

> §10.28 Fees. (b) Contingent fees for return preparation: A practitioner may not charge a contingent fee for preparing an original return. A practitioner may charge a contingent fee for preparing an amended return or a claim for refund (other than a claim for refund made on an original return) if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended return or claim will receive substantive review by the Service. A contingent fee includes a fee that is based on a percentage of the refund on a return or a percentage of the taxes saved, or that otherwise depends on the specific result attained.

The author believes that the preparer can reasonably anticipate that the claim for refund or supplemental information will receive substantive review.

Include in your letter all expenses charged through to the client, such as copies, postage, telephone, filing fees, etc. A well written fee description will include a statement as to the payment policies (i.e., monthly invoices due upon receipt, upon approval by the court). If monthly invoices are sent, include a reservation to withdraw from the representation if any fee remains unpaid. You should also consider including a provision for arbitration of any fee dispute.

[6] Termination

The engagement letter should state when the client may terminate the relationship and when the attorney can terminate. A client can usually terminate for any reason, reasonable or not. The attorney may want to terminate in the event a conflict of interest (in the broad sense) occurs or a fee statement is not paid. Also, the engagement should terminate once the preparer has completed preparation of the return and its acceptance by the IRS. An alternative would be termination upon distribution of the estate.

[7] Required disclosures

Depending upon the practice of the preparer (attorney, accountant) and the state of practice, certain matters must be disclosed, preferably in an engagement letter, and some disclosures are necessary when including a particular provision as part of the engagement. These are requirements for attorneys in Texas:

[a] The Texas Supreme Court has issued a requirement that Texas lawyers inform clients of the content of the Texas Lawyers Creed. In the sample engagement letter, this is Attachment A.

[b] Texas lawyers must inform clients how to report professional misconduct. Notification can be in a sign in the firm reception room, a statement on the invoice, or in the engagement letter. The notification is included in the sample engagement letter as Attachment B.

[c] The requirements to include a privacy policy notice, in the sample engagement letter as Attachment C, are discussed below in the section entitled "Confidentiality." Gramm-Leach-Bliley Act, 15 U.S.C. §§6801-6810.

[d] Opinion 409 (January 1984) of the Committee on Professional Ethics, State Bar of Texas, permits charging interest on outstanding invoices provided notification is made in the engagement letter and the original fee and interest charged are reasonable.

[e] When a retainer is requested, the retainer must be kept in a client trust account and notice in the engagement letter regarding the retainer is required. Tex. Disciplinary R. Prof'1 Conduct 1.14 (property belonging to clients "shall be kept in a separate account designated as a 'trust' or 'escrow' account").

[f] Arbitration on fee disputes can be imposed if an arbitration notice is set forth in the letter. At least one corporate fiduciary trust officer has stated to your author that agreement to arbitration would be a violation of its fiduciary duty. Texas General Arbitration Act, Tex. Civ. Prac. and Rem. Code §§171.000, et. seq.

[F] Commitments as to results

Never make a commitment as to the results to be obtained either as to the probate procedure or the tax administration. Consider adding a statement that affirmatively states that no commitments are made. The cautious preparer may want to include a statement to the effect that the client recognizes that even a routine filing with the Internal Revenue Service may trigger an unexpected result.

[G] Non-engagement letter

If you have discussed with a potential client the possible representation in preparing the Form 706 and you decide to not accept that representation, consider sending a non-engagement letter stating that you are not representing that person in preparing the Form 706, that the person's responsibilities may be subject to statutes of limitation and he or she should consider engaging another attorney or accountant to advise them. This will protect you from claims if the executor misses a filing deadline and increased tax is imposed.

[H] Schedule for completion

Model Rule 1.3, entitled "Diligence" states, "A lawyer shall act with reasonable diligence and promptness in representing a client." The ACTEC Commentaries on the Model Rules of Professional Conduct as to Model Rule 1.3 suggest that it is advisable at the outset of the engagement to establish a timetable for completion of the work. The importance of timely filing a properly prepared Form 706 and the complexity involved, means that a time schedule for the various steps leading up to filing deadlines is necessary. The accompanying Table 1, Time Table for Preparing and Filing Form 706, illustrates a schedule for orderly preparation of the estate tax return. Where the task of preparation will be particularly complex, due to the nature or quantity of assets in the estate, the time line may include regular meetings of the executors, accountant, attorney, and possibly family. The prospect of appearing unprepared for a meeting may be a needed impetus to action for all concerned.

[I] Standard of conduct

The preparer must not provide false or misleading information to the IRS and must not counsel the executor on how to evade any Federal tax, including estate taxes. Treas. Circular 230 provides this standard of conduct:

> §10.51 Disreputable conduct. Disreputable conduct for which an attorney, certified public accountant, enrolled agent, or enrolled actuary may be disbarred or suspended from practice before the Internal Revenue Service includes, but is not limited to:
>
> (b) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof,

Table 1
Time Table for Preparing and Filing Form 706
(Assuming 3/01/02 DOD)

1 month	04-01-02	Engagement letter signed	See Appendix B
1 month	04-01-02	Initial information from client	
1.5 mos.	04-15-02	Request for information to client	See Appendix F
2 months	05-01-02	Household goods appraisal	
2 months	05-01-02	Request extension to file inventory	
3 months	06-01-02	Second information from client	
3 months	06-01-02	Engage business and real estate appraisers	
4 months	07-01-02	Final information to business appraiser	
5 months	08-01-02	Third information from client	
5 months	08-15-02	Memo to client detailing information still needed	
6 months	09-01-02	Draft business and real estate appraisals received Final information from client	
6.5 mos.	09-15-02	Discuss draft appraisals with appraisers	
7 months	10-01-02	Business and real estate appraisals completed	
7.5 mos.	10-15-02	Target date for draft return to partner for peer review	
8 months	11-01-02	Target date for draft return to client with explanation memo	See Appendix A
before or on 9 mos.	11-29-02	Disclaimer deadline	Last business day when nine months is on weekend or holiday
9 months	12-01-02	Nine month date	Sunday
9 months	12-02-02	Estate tax due Return due with no extensions Extension request due	Due date when 9 month day is weekend or Sunday
14 months	05-01-03	Information from client on changed facts	
14.5 mos.	05-15-03	Prepare final return to be filed	
15 months	06-01-03	Estate tax return due with extensions	
15 months	06-01-03	File probate inventory	

> or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term "information."
>
> (d) Willfully failing: [sic] to make a Federal tax return in violation of the revenue laws of the United States, or evading, attempting to evade, or participating in any way in evading or attempting to evade any Federal tax or payment thereof, knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof, or concealing assets of himself or another to evade Federal taxes or payment thereof.

These requirements substantially track the criminal fraud provisions of IRC § 7206(2). Further, the preparer must exercise due diligence as to the accuracy of the return. Due diligence is required in Treas. Circular 230:

> §10.22 Diligence as to accuracy. Each attorney, certified public accountant, enrolled agent, or enrolled actuary shall exercise due diligence:
>
> (a) In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
>
> (b) In determining the correctness of oral or written representations made by him to the Department of the Treasury; and
>
> (c) In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the Internal Revenue Service.

[J] File ownership

The question may arise as to who owns the file, the attorney preparer or the executor, and this question usually arises when there is some dissatisfaction in the preparer-executor relationship. The attorney preparer will probably desire to retain the file, but the practical realities of the disciplinary rules probably mean that the file will need to be turned over, the only issue being under what terms.

The executor owns the file unless the engagement letter by contract changes that rule. Certain items need to be returned upon request: (1) executor-provided documents; (2) legal memoranda produced as part of the representation; (3) worksheets created in preparation of the return; (4) appraisal reports for which the executor has paid; (5) correspondence with third parties, and (6) electronic media or hard copy of the draft return if not yet filed.

Items which need not be returned include: (1) billing documents including draft invoices and copies of invoices provided to the executor; (2) executor-preparer correspondence; (3) preparer notes from conferences with the executor or third parties; (4) appraisal reports for which the executor has not paid directly or reimbursed the preparer; and (5) internal memos and messages including email.

An illustration or example may be helpful. If the return has been filed and a complete copy of the return as filed was provided to the executor, the preparer need not turn over the preparer's copy, but if the executor cannot locate the executor's copy, the preparer should provide a copy made from the preparer's copy and that copy should be provided when the executor agrees in advance to pay the copy cost. But correspondence with third parties or worksheets not previously provided should be returned without additional charge to the executor.

The preparer may have a lien on the file to secure payment of any outstanding fees. But, the attorney cannot retain the file when the executor needs the file to complete filing of the estate tax return or defend in the event of an audit or other administrative proceeding.

> Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interest, such as . . . surrendering papers and property which the client is entitled . . . the lawyer may retain papers relating to the client to the extent permitted by other law if such retention will not prejudice the client in the subject matter of the representation.
>
> Disciplinary Rules of Professional Conduct, Rule 1.15(d).

Ethical issues may also arise as to general legal matters if the attorney is asserting a retaining lien and (i) the documents are necessary and the client is of limited resources, (ii) retaining documents will prejudice the client's pending litigation, (iii) the property was provided to the attorney for a specific purpose, or (iv) there is an issue regarding the propriety of the fee in dispute. 69 ALR 4th 974 (1989). Point (i) will seldom apply to preparing an estate tax return, and point (ii) will be seen as applicable if timely filing of an estate tax return is substituted for pending litigation, while points (iii) and (iv) are as applicable to preparing estate tax returns as they are generally. Papers the most valuable to an executor and providing the attorney-preparer the greatest leverage in recovering unpaid fees and expenses, will be the papers that the attorney-preparer will least likely be able to retain because they will have the most prejudicial effect on the executor's rights. In the vast majority of cases when faced with a demand for the file, the preparer will have great difficulty in refusing the demand to

secure payment of outstanding fees. In summary, the attorney's lien is a right held by the attorney-preparer, but in the final analysis, it is not much of a right because the exceptions swallow the rule.

In any instance in which the file is being transferred because of executor unhappiness with the performance of the preparer or because the possibility of a lawsuit by the executor is greater than a mere possibility, consider going the extra expense to have the file being returned both bates stamped (numbered consecutively, usually with an identifying initial) and copied for retention by the preparer. Every returned file should be reviewed document-by-document to make sure that only appropriate and required documents are turned over to the executor. Turning over more than what is required unnecessarily invites a lawsuit.

Your author's current practice does not include placing in the engagement letter a provision regarding the file, but possibly you may wish to include such a statement regarding file ownership, possibly something like this:

> There may be an additional charge for additional copies of all correspondence between us, billing information, or other documents previously provided by us. It is the policy of this firm to not provide notes prepared by the attorney nor appraisals paid for by the firm and not reimbursed by the executor. The firm will enforce any liens the firm may have on the file for any invoiced and unpaid fees at the time it is requested that the file be returned or provided to another.

> The interesting thing is that when it comes to the tax code of the United States, Americans are very egalitarian. Middle-income taxpayers support repeal of the death tax, for example, even though they know it will never help them.
>
> U.S. Sen. John Kyl (R) AZ
> (Quoted in the Washington Post)
> as in the San Antonio Express News,
> July 25, 2004

§1.05 *Estates that must file*

[A] Minimum amount

The instructions provide that the Form 706 must be filed when the gross estate, plus adjusted taxable gifts and specific exemption are more than $1 million for deaths in 2003, or $1.5 million for deaths in 2004, or the applicable exclusion amount for the year of death. To determine if a return must be filed, add:

(i) the adjusted taxable gifts (under Section 2001(b)) made by the decedent after December 31, 1976 (other than gifts included in decedent's gross estate);

(ii) the total specific exemption allowed under Section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976; and

(iii) the decedent's gross estate valued at the date of death. Instructions to the Form 706 (hereinafter the "Instructions"), p. 1. Only one-half of qualified joint interests, Schedule E, are counted.

Lifetime taxable gifts must be taken into consideration, and it is incorrect to solely consider the value of the gross estate on the date of death.

[1] Non-owned assets included

The estate tax is a tax on the value of property transferred at death and not a tax on the property itself. The tax reaches property owned by the decedent as well as property not actually owned by the decedent, including certain transfers within three years of death, retained life estates, revocable transfers and transfers taking effect at death.

[2] Deductions disregarded

When the sum is equal to or greater than the applicable exclusion amount for the year of death, then a Form 706 must be filed even if the deductions reduce the total below the applicable exclusion amount.

[3] Alternate valuation disregarded

The value at the date of death is determinative, even if alternate valuation under IRC § 2032 is elected, and that value is less than the minimum amount. Treas. Reg. §20.6018-1(a).

[4] Special use valuation disregarded

Reductions attributable to IRC § 2032A Special Use Valuation are disregarded in finding whether the minimum filing amount is met.

[B] Applicable exclusion amount

As a result of the Tax Reform Act of 1976, the unified credit was an important part of calculating the estate or gift tax, but after the Taxpayer Relief Act of 1997, the credit was defined as an "applicable credit amount" with reference to an "applicable exclusion amount." Table 2, Applicable Exclusion Amount Pre-EGTRRA 2001, sets forth the applicable exclusion amounts as provided in the Taxpayer Relief Act of 1997.

As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA 2001"), the applicable exclusion amount for 2002 is $1,000,000 with gradual increases until repeal in 2010. Table 3, Applicable Exclusion Amount Post-EGTRRA 2001 sets forth the exclusion amounts under current law.

[1] Permanent repeal

On April 13 the House of Representatives passed a bill to make the repeal of the estate tax permanent in 2011 and beyond. As of the writing of this the Senate has not acted.

Table 2 Applicable Exclusion Amount Pre- EGTRRA 2001		
For Decedents Dying In	Applicable Exclusion Amount	Unified Credit
1998	$625,000	$202,050
1999	650,000	211,300
2000 & 2001	675,000	220,550
2002 & 2003	700,000	229,800
2004	850,000	287,300
2005	950,000	326,300
2006 or after	1,000,000	345,800

Table 3 Applicable Exclusion Amount Post EGTRRA 2001		
For Decedents Dying In	Applicable Exclusion Amount	Unified Credit
2002	$1,000,000	$345,800
2003	1,000,000	345,800
2004	1,500,000	555,800
2005	1,500,000	555,800
2006	2,000,000	780,800
2007	2,000,000	780,800
2008	2,000,000	780,800
2009	3,500,000	1,455,800
2010	Repeal	-NA-

[2] Retroactive increase

If repeal were to come into effect, could the Congress bring the estate tax back retroactively? Presumably yes. A retroactive increase in the estate and gift tax rates under the Omnibus Budget Reconciliation Act of 1993 was upheld where there was a retroactive restoration of the maximum estate and gift tax rates of 55 and 53 percent, although the maximum rates had been reduced to 50 percent, approximately 7 months earlier. *Quarty v. United States*, 170 F.3d 961 (9th Cir. 1999), *NationsBank v. United States*, 44 Fed. Cl. 661, 666 (1999).

[C] Filing for borderline estates

When the gross estate exceeds the minimum amount for filing, even in close cases, the statute of limitations will not run unless a return is filed, even if no tax is due because of deductions. IRC § 6501. Even though a return may not be required, when the gross estate and adjusted taxable gifts are close, but less than the minimum amount for filing, a filed return should give statute of limitations protection if the return is accepted by the IRS. If the estate contains no hard-to-value assets, the author questions the need for the estate to incur the expense to prepare a return when estimates are that the minimum amounts for filing will not be reached. Be mindful that assets omitted in good faith need not be included in supplemental information when a return has been filed, but later discovered assets may require filing where the minimum filing amount is met and a return has not yet been filed. See Paragraph [C], "Omissions," in Section 1.16, "Deficiencies," below. It also appears questionable to incur the expense to file a return if the estate contains hard-to-value assets, unless the valuation issues can reasonably be found to be at amounts such that the minimum filing amount is significantly exceeded. Such cases where it only slightly exceeds the minimum filing amount, the risk of interest and penalties needs to be weighed against the possibility that the IRS will audit. Because returns not meeting the minimum filing amount may not be accepted as a return by the IRS, consider valuing the hard-to-value assets so that the minimum filing amount is met.

[D] U.S. citizens and residents

[1] U.S. residents

Filing a Form 706 is required for the estates of decedents who are U.S. citizens or U.S. residents at the time of death. The "United States" encompasses only the fifty states and the District of Columbia. Treas. Reg. §20.0-1(b)(1). "For estate tax purposes, a resident is someone who had a domicile in the United States at the time of death. A person acquires a domicile by living in a place for even a brief period of time, as long as the person had no intention of moving from that place." Instructions, p.1. "Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal." Treas. Reg. §20.0-1(b)(1). For Federal estate tax purposes the "substantial presence" test of IRC § 7701(b) does not apply. Domicile is based on intent and involves a subjective evaluation.

[2] Non-resident aliens

A Form 706-NA is filed for the estates of nonresident aliens, being decedents who were neither U.S. citizens nor residents at the time of death, if the gross estate exceeds $60,000. IRC § 6018(a)(2).

[3] Residents of U.S. Possessions

IRC §s 2208 and 2209 relate to decedents who were U.S. citizens and residents of a U.S. possession on the date of death. If such a decedent became a U.S. citizen only because of the decedent's

connection with a possession, then the decedent is considered a nonresident alien decedent for estate tax purposes, and the estate should file Form 706-NA. But if such a decedent became a U.S. citizen wholly independently of his or her connection with a possession, then the decedent is considered a U.S. citizen for estate tax purposes, and the estate should file Form 706. Instructions, p.2.

[4] Importance of residency

The differences in tax treatment for the estate of nonresidents and residents can make determination of residency an important consideration. An estate of a U.S. citizen and resident dying in 2003 must file a return if the gross estate equals $1,000,000, but a non-resident files when the federal gross estate equals $60,000.

[5] U.S. citizens, non-residents

The Instructions provide that where a U.S. citizen is not a resident of the United States, the following documents must be attached:

> (1) A copy of the inventory of property and the schedule of liabilities, claims against the estate, and expenses of administration filed with the foreign court of probate jurisdiction, certified by a proper official of the court;
>
> (2) A copy of the return filed under the foreign inheritance, estate, legacy, succession tax, or other death tax act, certified by a proper official of the foreign tax department, if the estate is subject to such a foreign tax; and
>
> (3) If the decedent died testate, a certified copy of the will.

Instructions, p. 2.

§1.06 *Obtaining the information*

One of the difficulties encountered in preparing the estate tax return is finding information on property owned by a person when the one most knowledgeable, the decedent, is unable to provide information.

> The King of England 500 years ago sent an official known as the Crowner to figure out how much money was due to the Crown from the estate of anybody who died. Later that official also was called upon to determine the cause of death. The title "Crowner" involved into "coroner".
>
> L.M. Boyd Revisited

[A] Executor responsible

The preparer must rely on the executor for the information to prepare the return. In *Trompeter v. Comm.*, TC Memo 1998-35, the Tax Court addressed "giving implausible or inconsistent explanations of behavior" as an indicia of fraud in deciding whether the executors had fraudulent intent.

The preparer must rely on the executor for the information to prepare the return. In *Trompeter v. Comm.*, TC Memo 1998-35, the Tax Court addressed "giving implausible or inconsistent explanations of behavior" as an indicia of fraud in deciding whether the executors had fraudulent intent.

> Ms. Gonzalez (a co-executor) also testified that *she intentionally kept documents from Ms. Bates, the estate's tax preparer*, [emphasis added] testifying with respect to Mr. Liedman's $8.5 million appraisal, that she did not think the appraisal was relevant to the estate's valuation of the 191 coins. The appraisal was relevant to Ms. Bates' reporting of that value, and Ms. Gonzalez' secretion of that and other documents from Ms. Bates is an example of implausible behavior under the facts herein.
>
> Ms. Gonzalez also testified incredibly that she did not know that she had signed the decedent's estate tax return under the penalties of perjury. Ms. Gonzalez is college educated, and she has prior work experience. She also is knowledgeable on, and has experience with, her personal income tax returns which are filed under penalties of perjury.
>
> We conclude that this factor evidences fraud.

Trompeter illustrates that an executor's failure to provide all relevant information to the preparer may have a worse consequence than paying estate tax.

[B] Information review

Checklist 2, Information Review Checklist, lists places to obtain information to complete the Form 706.

> **Checklist 2**
> **Information Review Checklist**
>
> - ❑ Client questionnaire, Appendix C
> - ❑ Income tax returns
> - ❑ Check registers, cancelled checks, and deposit tickets
> - ❑ Balance sheets, statement of net worth
> - ❑ Insurance policies
> - ❑ Decedent's mail
> - ❑ Previous estate tax returns
> - ❑ Decedent's will
> - ❑ Decedent's employer
> - ❑ Unclaimed property listings.

[1] Client questionnaire

A questionnaire may be a good way to obtain information from the executor. For a sample questionnaire, see, Yale, "Obtaining Information to Complete the Form 706," Practical Tax Lawyer, Summer 1999, attached at Appendix C.

[2] Review income tax return

The decedent's return is to be available to the administrator, executor or trustee of the decedent's estate, IRC § 6103(e)(3), as person's with a material interest. The return is also to be made available to any heir at low, next of kin, beneficiary under the will or donee of property, but only if the IRS finds that the heir, next of kin, beneficiary or donee has a material interest that will be affected by the information contained in the return.

In Rev. Rul. 2004-68, 2004-31 IRB 118, the Service ruled that the income tax return of an intestate decedent for the calendar year prior to the decedent's death shall be open to inspection or disclosure to any heir at law or next of kin who is a distributee as determined under applicable state law of the decedent's probate estate, and the existence of a material interest of such a person that is affected by information contained in that return will be presumed.

Review of the decedent's income tax returns may reveal previously undisclosed assets. The examiner, upon audit, is to review the decedent's final income tax return and those for the three years prior to death. IRS Manual Supplement, 43G-17, May 19, 1976, so the careful preparer should review them when the Form 706 is being prepared.

[a] Form 1040, first and second page

❑ High income leads one to expect a substantial estate.

❑ Filing status and exemptions should be consistent with marital status and family reported on the estate tax return.

[b] Form 1040, Schedule A

❑ Real estate taxes deducted may indicate undisclosed real property.

❑ Mortgage interest deducted may indicate an undisclosed mortgage and possibly undisclosed real property as security.

❑ Charitable contribution deductions may indicate an undisclosed charitable pledge or a charitable remainder trust or gift annuity.

❑ Miscellaneous deduction for investment advice indicates investments.

❑ Miscellaneous deductions for a safe deposit box indicates one exists.

[c] Form 1040, Schedule B

❑ Interest indicates bonds, mortgages, notes, and cash. Trace back to the particular investment giving rise to the income.

❑ Dividends indicate stocks. Look for stocks listed in Part II.

❑ A "yes" answer to an account in a foreign country indicates that it should be included in the estate.

❑ A "yes" answer to distributions from grantor or transfers to a foreign trust indicates a trust to be reported on Schedules F or G.

[d] Form 1040, Schedule C

❑ A business shown here may need to be listed on Form 706, Schedule F.

❑ Expenses here may indicate assets that should be reported on Schedule F as part of the sole proprietorship.

[e] Form 1040, Schedule D

❑ Trace substantial sales proceeds ("sales price") through to assets in the estate.

[f] Form 1040, Schedule E

❑ Real property producing the rent, royalty or farm income may need to be listed on Schedule A.

❑ Auto expenses may indicate an automobile.

❑ Expenses may indicate mortgages and debts to be reported on Form 706, Schedule K.

❑ Expenses, if ongoing, may indicate post-mortem expenses that may be deductible on Schedule J.

❑ Income or loss from a partnership indicates a partnership interest.

❑ Income or loss from an S corporation indicates an S corporation interest.

❑ Income or loss from an estate indicates an interest in an estate.

❑ Income or loss from a trust indicates an interest in a trust.

[g] Form 1040, Schedule

❑ Expenses may indicate the presence of livestock, crops, machinery, or other farm assets to be reported on Schedule F.

❑ Agricultural program payments may indicate agricultural rights (ability to produce crops for sale) to be reported on Schedule F.

[h] Form 1040, Schedule K-1

❑ Partnership K-1s indicate a partnership to be reported on Form 706, Schedule F.

❑ S corporation K-1s indicate a closely held corporation to be listed on Form 706, Schedule B.

❑ Trust or estate K-1s indicate a trust includable in the decedent's estate and reported on Form 706, Schedule G.

❑ Trust K-1s may indicate "stub-income," to be reported on Schedule F.

- ❑ Trust K-1s for non-included trusts require a "yes" to Form 706, Part 4, Item 12b and reporting on Schedule G.

[3] Review check registers, cancelled checks and deposit tickets

The auditor, upon audit, will request 3 years of the decedent's cancelled checks. A careful preparer will review them as part of preparing the Form 706, to anticipate the auditor's inquiries on what they reveal. This checklist is a brief sampling of what the checks may disclose.

- ❑ Large checks to brokerage firms, investment houses or banks may indicate previously undiscovered investments.
- ❑ Large checks to jewelry stores may indicate undisclosed jewelry.
- ❑ Large checks to antique stores or art galleries may indicate undisclosed valuables or art.
- ❑ Recurring checks may indicate a debt.
- ❑ Checks to family members may indicate unreported taxable gifts.
- ❑ Checks to a mortgage company or a lender reveals the underlying debt.
- ❑ A deposit ticket may reveal the source of funds.

[4] Balance sheets, statements of net worth

Personal balance sheets and statements of net worth, whether prepared by the decedent or the decedent's accountant, can be "statements against interest." Valuation questions can be harmed and seldom helped by figures on a balance sheet, even if roughed out by hand by the decedent as part of an application for a loan. While the estate may be able to distinguish a valuation figure, it will be near impossible to avoid inclusion of an asset listed on the statement.

In *Trompeter v. Comm.*, TC Memo 1998-35, the co-executors, daughters of the decedent, had to admit to inclusion in the estate of a gun collection, a music collection and diamonds and gems not included on the estate tax return where the decedent before his death instructed his account-ant to prepare a list of the decedent's assets and each asset's estimated value. The case does not explicitly say so, but it appears that the executors had to accept the values on the list because of their failure to report the items originally.

[5] Review insurance policies

Homeowners, property, or casualty insurance policies may reveal previously undiscovered property.

[6] Review decedent's mail

Monitoring decedent's mail for bills, tax statements, financial statements, etc. will provide clues to debts and assets.

[7] Review previous estate tax returns

An estate tax return of the spouse or of a recently deceased parent may reveal assets and interests in trusts that decedent owned. If the decedent's spouse is predeceased, then the estate tax attorney with the IRS may compare the spouse's return with the decedent's return to trace assets from the spouse's estate to the decedent's estate. Estate Tax Audit Handbook, §356.

[8] Review decedent's will

There is an excellent chance that assets mentioned in decedent's will were owned on the date of death.

[9] Contact decedent's employer

A decedent actively employed or retired from an employer may have benefits through the company that require reporting.

[10] Unclaimed property

The personal representative should check the unclaimed property agency for the decedent's state of residence and any other state of which the decedent may have been a resident or temporary resident for the last several years' of life. According to Missing.Money.Com, discussed below, common types of unclaimed property include bank accounts and safe deposit box contents; stocks, mutual funds, bonds, and dividends; uncashed checks and wages; insurance policies, CD's, trust funds; and utility deposits and escrow accounts, but unclaimed property does not include real estate property.

Agencies can be located on the web at www.unclaimed.org, the site of the National Association of Unclaimed Property Administrators. Click on the "Owners" link and then "Find Property" to see the map and pull down menu with links or information on all 50 states unclaimed property as well as several territories. The NAUPA and participating states permit a national search at www.missingmoney.com. As of January 1, 2005, the site listed property from these states: Alaska, Arizona, Colorado, District of Columbia, Florida, Idaho, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Montana, New Hampshire, New Jersey, North Dakota, South Dakota, Vermont, West Virginia, and Wisconsin with Oklahoma and Puerto Rico to be added soon. Another site is operated by the National Unclaimed Property Database, www.nupd.com, which states that it includes Canada and the Federal government, but it

appears to be a private site that requires registration to use so the user will be subjected to banner ads.

[C] Affirmative duty to produce

There is an affirmative duty upon the executor to produce records and upon persons in possession of property included in the gross estate, which presumably would also include records of the decedent, to produce them subject to a relatively modest $500 fine.

> Sec. 7269. Whoever fails to comply with any duty imposed upon him by section 6018, 6036 (in the case of an executor), or 6075(a), or, having in his possession or control any record, file, or paper, containing or supposed to contain any information concerning the estate of the decedent, or, having in his possession or control any property comprised in the gross estate of the decedent, fails to exhibit the same upon request to the Secretary who desires to examine the same in the performance of his duties under chapter 11 (relating to estate taxes), shall be liable to a penalty of not exceeding $500, to be recovered, with costs of suit, in a civil action in the name of the United States.

There appears to be no penalty if the decedent destroys documents during life.

§1.07 *Organizing the information*

[A] Folders

Organization should start early for possibly hundreds of pages of documents necessary to obtain the information for the return as well as to identify required supplemental documents. A suggestion is a labeled folder for the required information and each schedule to be included in the return. Table 4, File Folders List, contains a suggested list of file folders.

[B] Documents included

Place in each folder the following:

(1) Clip on one side the supplemental documents that will be filed with the return, such as appraisals, deeds, mortgage notes, Form 712, trust agreements, etc., with the schedule letter and item number on a sticky note.

(2) Clip on the other side documents that are provided to the client and accountant as support for the entries on the return, such as bank statements, signature cards, etc., but are not filed with the return, with the schedule letter and item number on a sticky note.

(3) Clip on the same side as 2., under a colored sheet, documents that generally relate to the items listed on that schedule but need not be filed with the return or provided to the client.

For any schedule generating a substantial number of documents, prepare additional folders as appropriate.

§1.08 *Where filed*

[A] Residents

For U.S. residents, the return may be hand carried to the office of the District Director or mailed to the Cincinnati Service Center, Cincinnati, Ohio 45999. They are no longer mailed to the regional service center where income tax returns are filed. IRS Announcement 2001-74.

If the return is mailed other than to the Cincinnati Service Center, it will not be considered filed until the earliest date it could have been received by transfer by the Cincinnati Service Center. In *Winnett v. Commissioner*, 96 TC 802 (1991), the Tax Court held that for purposes of determining the commencement of the limitations period when the timely mailing rule does not apply, "a return is not deemed 'filed' until it is received by the revenue office designated to receive such return." *Id*. 808. While *Winnett* dealt with an income tax return, the holding most probably also applies to estate tax returns.

Table 4 – File Folders List

- Form 706, General Information
- Certified Will (Trust Agreement)
- Death Certificate
- Gift Tax Returns
- Schedule A - Real Estate
- Appraisals (for each appraised property)
- Schedule B - Stocks & Bonds
- Appraisals (for each closely held business)
- Schedule C - Mortgages, Notes & Cash
- Bank Statements & Cancelled Checks (for ea. acct.)
- Schedule D - Life Insurance
- Schedule E - Jointly Owned Property
- [Individual files as appropriate for certain assets]
- Schedule F – Miscellaneous
- Appraisals (for each partnership)
- [Individual files as appropriate for certain assets]
- Schedule G - Transfers During Decedent's Life
- Bank Statements & Cancelled Checks (for each acct.)
- Schedule I - Annuities
- Schedule J - Funeral and Administration Expenses
- Schedule K – Debts
- Schedule L - Net Losses During Administration
- Schedule M - Marital Deduction
- Certified order admitting will
- Schedule O - Charitable Deduction
- Certified Order admitting will (if no marital deduction)
- Schedule P - Previously Taxed Property
- Schedule R - Generation- Skipping Transfers
- Schedule T - Qualified Family Owned Business
- Schedule U - Qualified Conservation Easement
- Closing Letter
- Decedent's Income Tax Returns

[1] Hand carried

When taken to an office of the District Director the IRS employee will usually file stamp a copy of the front page of the return as proof of filing. The regulations have a definition of "hand-carried,"

being brought to the district director by the person required to file the return or his agent. Agents include members of the executor's family, an employee of the executor, the executor's attorney, accountant or tax advisor, and messengers employed by the taxpayer. Treas. Reg. §301.6091-1(c). A good practice is to prepare a receipt stating that a Form 706 is filed and a check for the tax is paid with the return. Document 1 is a sample receipt that may be used when a hand carried return is filed. Sometimes the IRS will stamp the receipt and sometimes they will not. Typically they will not stamp a copy of the front page provided by the taxpayer, but rather will insist on stamping a photocopy they make from the return filed. The local office will usually negotiate any check delivered in payment of taxes before sending the return on for processing. Filing late in the date may result in additional float on the check as opposed to filing early in the day.

[2] Mailed

Mailed returns are best sent certified mail, return receipt requested. IRC § 7502(a)(1) provides a statutory timely mailing as timely filing rule by providing that the date of the United States postmark stamped on the cover in which the return or payment is mailed shall be deemed to be the date of delivery or payment. Section 7502(c) provides that for items sent by United States registered mail, the date of registration shall be the postmark date and the registration shall be prima facie evidence that the items were delivered to the addressee. The regulations, §301.7502-1(g), provide a similar rule for certified mail. This statutory postmark rule is different from the common law mail box rule, under which timely mailing will be timely filing if the IRS cannot produce evidence of not receiving the return. *Estate of Wood v. Comm*., 909 F.2d 1155, 1158 (8th Cir. 1990). The mail box rule has been stated as:

> When mail matter is properly addressed and deposited in the United States mails, with postage duly prepaid thereon, there is a rebuttable presumption of fact that it was received by the addressee in the ordinary course of the mail... Proof of due mailing is prima facie evidence of receipt. It follows that the proof of regular mailing, in time to reach the [IRS], in due course of mail within the statutory filing period, [is] sufficient to support a finding that the return was timely filed. *Crude Oil Corp. v. Comm.*, 161 F.2d 809, 810 (10th Cir. 1947).

In addition to the Tenth Circuit, the common law mail box rule has been accepted in the Eighth and Ninth Circuits as well as the Tax Court, but rejected in the Second and Sixth Circuits. A recent case, *Sorrentino v. U.S.* 89 AFTR 2d 2002-856, has an excellent discussion of how the common law mail box rule can trump the statutory postmark rule, and discusses evidence that either the taxpayer or the IRS can use to rebut the rule. Because the IRS can rebut the rule, a mailed return is best sent registered mail or certified mail. See an excellent discussion of problems of mailing a return in Berall, "Transfer Tax Procedural Changes Due to Recent Developments," *The Practical Tax Lawyer*, Spring 1999.

When mailing, consider including an extra copy of the cover letter and the first page of the return with a request in the cover letter that the IRS stamp the letter and the first page of the return and return them to the executor. See Document 2 – Transmittal Letter for an example of a transmittal letter for mailing a return.

A mailing receipt is not prima facia proof that the return was timely mailed. Because registered and certified mail have the presumption of timely filing upon timely mailing, do not rely on just a mailing receipt.

[3] Private delivery services

IRC § 7502(f) expands the "timely mailed timely filed" rule to designated private delivery services. See, Rev.Proc. 97-19, 1997-1 CB 644, Notice 97-26, 1997-1 CB 413, Notice 97-50, 1997-2 CB 305, and Notice 98-47, 1998-37 I.R.B. 8. The private delivery service address is: Internal Revenue Service Center, 201 W. Rivercenter Blvd., Covington, KY 41019. The approved delivery services and the approved types of service are listed in Instructions, p. 2. The instructions state that when using a private delivery service, ask them to explain how to obtain written proof of the mailing date. *Id*. If a substantial check is being sent to pay taxes, regular

DELIVERY RECEIPT

TO: Internal Revenue Service
5835 Callaghan Road
San Antonio, Texas 78228

Re:: Estate of _____
Social Security No: _____
Date of Death: _____

This is to acknowledge receipt of the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, accompanying Schedules and attachments for the Estate of _____.

This is also to acknowledge receipt of Check No. _____ in the amount of $_____ in payment of the estate tax due and owing.

Internal Revenue Service

By: _____

_____
(Date)

mail may be preferable to expedited service from a private delivery service.

[4] Mailed in and private delivery services from foreign countries

Rev.Rul. 2002-23, 2002-1 CB 812, states that the Internal Revenue Service will accept as timely filed any federal tax return, claim for refund, statement, or other document required or permitted to be filed with the IRS that is mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing, including any extension of time for filing. If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of IRC § 7503, then returns, claims, statements, and other documents will be considered timely if postmarked on or before the next succeeding day which is not a Saturday, Sunday, or a legal holiday.

Notice that this revenue ruling does not take into account any holidays of the foreign country which make it impossible to file on the due date. Also a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Internal Revenue Service or with the United States Tax Court that is given to a designated international delivery service before midnight on the last day prescribed for filing shall be deemed timely filed pursuant to IRC § 7502(a), (d)(1), and (f)(1). If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of IRC § 7503, returns, claims, statements, and other documents will be considered timely if given to a designated international delivery service before midnight on the next succeeding day that is not a Saturday, Sunday, or a legal holiday. See the section below entitled, "When due" for a discussion of legal holidays.

Document 2 – Transmittal Letter

January 16, 2004
Internal Revenue Service
Cincinnati, OH 45999

Re: Estate of John Q. Sample

Enclosed please find Federal Form 706 together with the Texas Inheritance Tax Return for the Estate of John Q. Sample. John Q. Sample died September 30, 2003. An extension request (Form 4768) was filed with the Internal Revenue Service and the Texas State Comptroller. A copy of the approved extension is attached.

No Tax is due on this estate.
[OR]
Enclosed is a check for $130,040.00 for payment of Federal estate tax.

Enclosed please find copies of this letter and page one of the Form 706. Please date-stamp these copies and return them to me at the above address.

Sincerely yours,

Glen A. Yale

Enclosures (as noted)

cc: Richard V. Sample
Independent Executor

[5] Electronic filing

As of yet the IRS has not provided for electronic filing of the Form 706. The required supplemental documents such as death certificates and certified wills may make electronic filing long in coming.

[6] Problems when filing

Because the IRS internal manual says that estate tax returns are to be stamped with the date the return is received, it is important to retain proof of the date the return is sent. Although a seven day grace period is given, it may not be sufficient. If you receive a Notice of Late Filing, call the estate tax hotline at 866.699.4083.

[B] Nonresidents

A return for the estate of a non-resident U.S. citizen should be mailed to the Internal Revenue Service Center, Philadelphia, PA 19255, U.S.A. The IRS will accept as timely filed a return mailed from, and officially postmarked in, a foreign country on or before the prescribed filing date, including extensions.

§1.09 *Date of death*

No taxation without respiration.

Rep. Bob Shaffer, a Colorado Republican who wants to abolish estate taxes.
Quoted in *Wall Street Journal*, July 12, 1997.

[A] Death certificate

The date of death usually is shown on the death certificate and a certified copy of it must be filed with the return.

[B] U.S. death

The exact time and date of death of a U.S. resident is standard time and the date prevailing in the decedent's domicile in the U.S. at the instant of death, even if the decedent died in a time zone different from that of the domicile. Rev. Rul. 74-424, 1974-2 CB 294.

[C] Foreign death

If a U.S. citizen dies in the foreign country of his or her domicile, the date and time of death is the established day and time in decedent's foreign domicile at the moment of death, not the day and time in the U.S. where the estate tax return is filed. Rev. Rul. 74-424, 1974-2 CB 274.

[D] Presumptive death

In the case of presumptive death, is the date of death the date of presumed death or the date the presumptive period ends? In PLR 8526007, the IRS ruled that where state law provides that an absentee is presumed dead if not heard from after a specified time, the date of death for estate tax filing purposes is the end of the presumptive period, rather than the date set by the court, citing Rev. Rul. 66-286, 1966-2 CB 285 and Rev.Rul. 80-347, 1980-2 CB 342, as requiring that where the gross estate exceeds the exemption, an estate tax return must be filed within 9 months following the date the absentee would be presumed dead using the seven years of the common law presumption of death or such other applicable state statutory period where state law has a period other than the common law period. Consider the application of the seven year period to persons first missing in 2003 rather than 2004.

The federal rule appears to conflict with the Texas rule, such that one could have one date of death for federal purposes and another date of death for Texas purposes. Tex. Tax Code §211.002 states,

> Date of Death of Presumed Decedent
>
> If a court enters a final decree presuming a missing person to be dead, the day of the person's death for purposes of this chapter is the day on which the court enters the decree establishing the fact of death regardless of the presumed day of death established by the decree.

> The only things in life that are certain are death and taxes.
>
> Benjamin Franklin
>
> The way you can tell the difference between the two is that death does not get any worse just because Congress is in session.
>
> Will Rogers

§1.10 *Who is responsible for payment?*

[A] Executor responsible

The estate tax is to be paid by the executor. IRC § 2002. The executor includes the executor or administrator of the decedent, and when there is no executor or administrator appointed, qualified and acting within the United States, it includes any person in actual or constructive possession of any property of the decedent. IRC § 2203.

[B] Executor personal liability

The executor is not personally responsible for the payment of the estate taxes if the assets in the estate decrease in value less than the amount of the taxes due, except to the extent the personal representative has made distributions from the estate. 31 U.S.C. §3713(b) (1994). A "representative of a person or an estate...paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government." This is sometimes referred to as "fiduciary liability." While not necessarily obvious from the statute, scienter by the executor is required. The Second Circuit held that the act makes an estate's personal representative personally liable for taxes, penalties, and interest upon proof by the government that (i) the personal representative distributed assets of the estate; (ii) the distribution rendered the estate insolvent; and (iii) the distribution took place after the personal representative had notice of the government's claim. *United States v. Coppola*, 85 F.3d 1015, 1020 (2nd Cir. 1996).

IRC § 6901 provides the method of collection for estate taxes under fiduciary liability, and provides, except as otherwise stated, fiduciary liability is "assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." The period of limitations for assessment of fiduciary liability is "not later than 1 year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is later." IRC § 6901(c)(3).

See, In re Daniel O. Tomlin Jr., 88 AFTR2d Par. 2001-5334 (N.D. Texas 2001), where the court held that a Texas estate executor owes a trust-type obligation to the IRS to pay federal estate taxes so that, if the executor's failure to do so is the result of fraud or defalcation, his personal indebtedness for the taxes is nondischargeable under 11 U.S.C. Section 523(a)(4) on the grounds that he is acting in a fiduciary capacity. The district court agreed with the bankruptcy court that under Texas law, an estate executor occupies a position of trust to all parties who have an interest in the estate, especially to creditors when the estate is insolvent, and that the executor's duty to creditors extends to the United States.

[C] Transferee liability

As stated earlier, when there is no executor or administrator appointed, qualified and acting in the United States (or that person fails to pay the tax), any person in actual or constructive possession of any property of the decedent is responsible for the tax to the extent of the value of the property and for interest and penalties. This includes surviving joint tenants, beneficiaries of life insurance, and the trustee of decedent's revocable living trust.

A trustee of a marital trust included in the decedent's estate for estate tax purposes was held by

the tax court to be personally liable for the decedent's unpaid estate tax, in *Estate of Irene H. Govern v. Comm.*, TC Memo 1996-434. The trustee was held to be liable for the estate tax deficiency as a transferee under IRC § 6324(a)(2) to the extent of the value of the trust assets.

In *Frank Armstrong, III v. Comm.*, 114 TC No. 5, the decedent made large gifts within three years of his death and paid the gift taxes due. Under IRC § 2035, the gift taxes paid within three years of death were included in the decedent's federal gross estate, but the gifts and payment of gift taxes brought the decedent's estate to near insolvency and there were insufficient assets remaining to pay the estate tax liability. The tax court held that the donees of the gifts were liable to pay the estate taxes due on the gift taxes on assets they received.

[D] Authority to collect

IRC § 7404 gives the IRS authority to collect under the provisions of general law estate tax not paid on or before the due date, or the Service may commence appropriate proceedings in the name of the United States in any court of the United States having jurisdiction to subject the property of the decedent to be sold under the judgment or decree of the court. From the proceeds of the sale the amount of the tax, interest, penalties, as well as cost and expenses of "every description" allowed by the court are to be paid and the balance deposited according to the order of the court.

§1.11 *When due*

The Form 706 must be filed on or before the due date, which is nine months after the date of the decedent's death, IRC § 6075(a), or the last day of the period covered by an extension of time. If there is no numerically corresponding day in the ninth month, the due date is the last day of the ninth month. For example, if the decedent died July 31, the return is due on April 30 of the next year. When the due date is on a Saturday, Sunday or legal holiday, the due date is the next succeeding day that is not a Saturday, Sunday or legal holiday. Treas. Reg. §20.6075-1. The term "legal holiday" is defined in IRC § 7503 as a legal holiday in the District of Columbia. The regulations refer to DC Code §28-2701.

> The following days in each year, namely, New Year's Day, January 1; Dr. Martin Luther King, Jr.'s Birthday, the third Monday in January; Washington's Birthday, the third Monday in February; Memorial Day, the last Monday in May; Independence Day, July 4; Labor Day, the first Monday in September; Columbus Day, the second Monday in October; Veteran's Day, November 11; Thanksgiving Day, the fourth Thursday in November; Christmas Day, December 25; every Saturday, after twelve o'clock noon; any day appointed by the President of the United States as a day of public feasting or thanksgiving; and the day of the inauguration of the President, in every fourth year, are holidays in the District for all purposes.

The statute also gives the rule for Saturdays and Sundays.

> When a day set apart as a legal holiday, other than the day of the inauguration of the president, falls on a Saturday, the next preceding day is a holiday. When a day set apart as a legal holiday falls on a Sunday, the next succeeding day is a holiday. In such cases, when a Sunday and a holiday or holidays fall on successive days, all commercial papers falling due on any of those days shall, for all purposes of presenting for payment or acceptance, be deemed to mature and be presentable for payment or acceptance on the next secular business day succeeding.

The IRC § 7503 continues:

> [I]n the case of any return, statement, or other document required to be filed, or any other act required under authority of the internal revenue laws to be performed, at any office of the Secretary or at any other office of the United States or any agency thereof, located outside the District of Columbia but within an internal revenue district, the term "legal holiday" also means a Statewide legal holiday in the State where such office is located.

[A] Deadline for disclaimers

Disclaimers must be filed within nine months of the date of death. But for disclaimers there is no weekend rule and there are no extensions. One must give careful consideration to whether disclaimers will improve the tax consequences imposed on the estate. Thus, even when an extension is used, a draft of the return as complete as possible should be prepared by the date eight months after the date of death. This will permit review of the return to determine if disclaimers are appropriate, and will give time to implement the disclaimer plan before the deadline for disclaimers passes. The one month period to implement the disclaimer plan will permit the attorneys for the estate to obtain any necessary court approval of disclaimers on behalf of incapacitated persons and minors.

[B] Late filing penalty

There is a late filing penalty of 5% of the tax per month not to exceed 25%. IRC § 6651(a)(1). One day late is equal to one whole month. The late filing penalty can be avoided when there is reasonable cause for the late filing. The burden is on the taxpayer to prove that the failure is due to reasonable cause and not willful neglect. *Boyle v. U.S.*, 469 U.S. 241, 245 (1985), and this is a "heavy burden." *Id*.

To establish reasonable cause, a taxpayer must show the exercise of ordinary business care and prudence and the inability to file the return or pay the tax within the proscribed time. Treas. Reg. §301.6651- 1(c)(1).

[1] Reliance on attorney

The executor's reliance on an attorney to timely file the estate tax return is not reasonable cause for purposes of avoiding the failure to pay penalty under IRC § 6651. *Boyle v. U.S.*, 469 U.S. 241, 249-250 (1985).

A taxpayer may establish reasonable cause for failing to file a timely return by establishing *reliance on the advice* of an accountant or attorney even if it is later established that such advice was erroneous. A taxpayer is not expected to discern error in the substantive advice of an accountant or attorney. *Estate of Thomas v. Comm.*, TC Memo. 2001-225, citing *Boyle v. U.S.*

In *Estate of Thomas*, the executrix argued reliance on the advice of her attorney and CPA, but her attorney testified that he never advised the executrix that no estate tax return was required to be filed and the CPA testified that he advised the executrix that the information needed to be collected and a return needed to be filed six years before it was actually filed. The estate failed to show that a 10-year delay was due to reasonable cause and not due to willful neglect.

The estate was not liable for late filing penalties in *Brown v. U.S*., 86-1 630 F.Supp. 57, 58-59 (M.D. Tenn. 1985), when an administrator's reliance on an attorney in filing an estate tax return three months late was reasonable cause; the attorney became seriously ill shortly before the return was due and the administrator's age (78), poor health, limited education (high school), and lack of experience (first time to serve as a fiduciary) rendered him incapable of exercising ordinary business care.

No reasonable cause for late filing a return was found for another inexperienced executor who relied on an attorney. *Estate of Harry K. Draper v. Comm*., 55 TCM (CCH) 797 (1988). The executor simply relied on the attorney to handle all estate matters, which the Tax Court distinguished from cases where the executor received erroneous advice. If no tax is due, a late filing penalty based upon the tax has no bite.

Neither an executor's misplaced assumption that no tax liability meant no return was required, nor a heavy workload as attorney, were reasonable cause for not filing. *Estate of Edith L. Bevan v. Comm*., TCM (CCH) 528 (1989).

[2] Reliance on accountant

The executor's reliance on an accountant to timely file the estate tax return was held to not be reasonable cause to avoid the penalty under IRC § 6651. *Cox Estate v. U.S*., 637 F.Supp. 1112, 1115 (S.D. Fla. 1986).

[3] No tax court jurisdiction

The tax court held it lacked jurisdiction under IRC § 6665 to review a penalty for late filing an estate tax return because no portion of the assessed addition to tax was attributable to a deficiency as defined in IRC § 6211. Under IRC 6665, the Tax Court has jurisdiction to review an addition to tax for late filing if the addition to tax is attributable to a deficiency in tax as defined under IRC § 6211. *Estate of Glenn G. Forgey v. Comm.*, 115 TC 142 (2000).

[4] Incomplete information

If the estate does not have the information to file a complete return, the best practice is to file a timely return based on the best information available and reasonable estimates, and later file supplemental information. See, *Estate of Thomas v. Comm.*, TC Memo. 2001-225. The regulations require a return as complete as possible, Treas. Reg. § 20.6081-1, and the return filed will be the return required. See discussions below on Deficiencies and Omissions.

[5] Abatement requests

If a return is filed late, should an abatement request accompany the late filed return? Accompanying the late filed return with the abatement request may increase the chances of a full audit. The abatement request alone will require the examiner to undertake a fair amount of review and fact finding to make a determination that the penalty abatement request meets the stringent standards of reasonable cause for abatement. From that review, opening a full audit may be a small step. If a late return is filed, it may be better to simply file the return and then file a separate request for abatement after the penalty notice is received. By that time, the return may have been set aside as not being audited.

[C] Late filing consequence

[1] Lost elections

The IRC § 6166 extended payout election and the allocation of GST exemption of a decedent are valid only if made on a return timely filed on the due date or with extensions. The QTIP, QDOT, alternate valuation date, and special use valuation elections may be made on late returns.

[2] Regulatory exception

PLR 200203031 involved application of Treas. Reg. §301.9100, discussed below, in the case of a Form 706 timely filed pursuant to an extension but

on which the executor had not unequivocally elected the alternate valuation date. The attorney tax return preparer did not advise the executor to make the election. After the return was accepted as filed and an estate tax return closing letter issued, the tax professional advised the executor that the alternate valuation date election should have been made on the original Form 706. The executor then planned to file a supplemental Form 706 making the alternate valuation date election. This private letter ruling cited the IRC § 2032(d)(2) rule not allowing an alternate valuation date election for a return filed more than a year after the due date including extensions, but held that the Treas. Reg. §301.9100 standards were met and an extension of time for making the alternate valuation date election was granted to the date the executor expected to file the supplemental Form 706.

[D] Late payment consequence

[1] Late payment penalty

IRC § 6651(a)(2) provides a penalty of 0.5 percent each month or fraction of a month that the tax is not paid up to a 25 percent penalty (50 months late). The penalty is not imposed if it is shown that the failure is due to reasonable cause and not due to willful neglect. Much of the discussion on failure to file, above, also applies to failure to pay. Treas. Reg. §301.6651-1 describes "reasonable cause."

A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he or she exercised ordinary business care and prudence in providing for payment of his or her tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he or she paid on the due date.

In *U.S. v. Boyle*, 469 U.S. 241, 245, the Supreme Court stated "To estop the penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from 'willful neglect' and (2) that the failure was 'due to reasonable cause.'"

Sowell v. U.S. 84 AFTR2d 99-5583 (5th Cir. 2001), shows that to avoid the IRC § 6651 late payment penalty, the executor should appeal any denial of an IRS extension request and make every reasonable effort to liquidate trust assets to pay the estate taxes. Decedent died in 1991 with most of her assets in two revocable trusts. The estate owed $2.3 million in federal estate taxes and $400,000 in state estate taxes and used $1 million in liquid assets to pay all the state liability and the rest to pay the federal liability, and then the estate requested an extension to pay the remainder of the federal liability. The IRS denial was not appealed. When the estate paid the remainder in 1996, the IRS assessed a late-payment penalty under IRC § 6651. The estate paid the penalty and filed a refund claim that was denied by the IRS. The estate brought suit and in a jury trial the IRS was upheld and then an appeal was brought. The appeals court rejected the estate's contentions that the trial court erred in not permitting the estate's expert to answer hypothetical questions concerning reasonable cause and in allowing the government to present evidence of events after the date the taxes were due. The court noted that the estate never attempted to obtain a loan to pay the taxes, that it failed to appeal the IRS' denial of its extension request, and that it never considered liquidating the trust assets. The court also noted that the IRS introduced evidence that the estate did not sue a QTIP trust for its allegedly illegal failure to contribute pro rata to the estate taxes, that the estate did not consider borrowing money from the more than sufficient QTIP trust, and that the estate took no action in an effort to pay the tax debt for four years.

Estate of Doster, TC Memo 2002-2, was another taxpayer failure to show reasonable cause why the IRC § 6651 addition to tax should be abated. The estate included a limited partnership that included lottery winnings paid in annual installments. The estate turned down an IRS offer on an installment agreement that would have diverted the partnership's income to the IRS for two years until the tax debt was paid.

[2] Interest on unpaid tax

Any amount of estate tax not paid on or before the due date, disregarding any extensions, will be assessed interest on the amount of such underpayment from the due date to the date paid. IRC § 6601(a).

§1.12 *Extensions*

A Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, can be filed to apply for an extension of time to file the estate tax return and extensions of time to pay the estate tax. Unless an extension to pay is filed with the extension to file, the tax is due on the regular due date for the return.

The Instructions to Form 4768 state that the extension request should be filed early enough to permit the IRS to consider the application and reply before the estate tax due date. If the extension request is filed just before the due date, the risk is run that the extension request will be denied for an insufficient showing of reasonable cause. Reasonable cause exists if the executor can show that the estate does not possess sufficient liquid assets to pay the estate tax and that the executor has made a reasonable effort to convert estate assets into cash.

[A] Extension to file

An extension to file may be desirable so development of facts between the tenth month and the fifteenth month results in the most advantageous amount of QTIP election or handling of various return items. Your author typically requests an extension to file. Any extension requested and granted need not be used.

[1] Extensions permitted

The filing of the return can be extended up to six (6) months. Only if the executor is abroad, can the extension exceed six months.

[2] Returns due prior to July 26, 2001

The application for the extension must set forth good and sufficient cause as to why it is impossible or impracticable for the executor to file a reasonably complete return on or before the due date. The extension request must contain a full recital of the causes for delay. Treas. Reg. §20.6081-1(a) & (b).

If reasonable grounds are given for requesting a filing extension, an extension will be granted, even if the application is made on the original due date. Reasons such as (i) additional time is required to determine the assets that are properly included in the estate; (ii) additional time is required to value the assets included in the estate; or (iii) additional time is needed to determine which elections, such as the QTIP election, should be made.

[3] Returns due after July 25, 2001

For returns due after July 25, 2001, the IRS issued final regulations, which provide in Treas. Reg. §20.6081-1(b) an automatic six month extension of time if Form 4768 is filed on or before the due date for filing Form 706.

An extension for good and sufficient cause, similar to that applicable for returns due prior to July 26, 2001, may be granted where the estate failed to request an automatic extension, or the executor is abroad and requesting an additional extension of time to file beyond the 6-month automatic extension. The Form 4768 must contain a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due dates. Curiously, this request should be filed before what would otherwise be the due date of the return and failure to file before that date may indicate negligence and constitute sufficient cause for denial of the extension! The Form 4768 must also contain an explanation showing good cause for not requesting the automatic extension. Treas. Reg. § 20.6081-1(c).

Document 2, Letter to Client with Application for Extension, is a cover letter to the client with the application for an extension without an application for extension to pay.

The automatic extension does not apply to Forms 706-A, 706-D, 706-NA or 706-QDT.

[B] Regulatory election extensions

Requests for extension of time for regulatory elections may be made under Treas. Reg. §301.9100-3, but not statutory elections. Regulatory election means an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin and a statutory election means an election whose due date is prescribed by statute. Requests for relief for extensions for regulatory elections will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interest of the Government.

A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer

(i) Requests relief under this section before the failure to make the regulatory election is discovered by IRS;

(ii) Failed to make the election because of intervening events beyond the taxpayer's control;

(iii) Failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;

(iv) Reasonably relied on the written advice of the IRS; or

(v) Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

A taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the professional was not (i) competent to render advice on the regulatory election, or (ii) aware of all relevant facts. Despite the conditions above showing that a taxpayer acted reasonably and in good faith, the taxpayer will be deemed to have not acted reasonably and in good faith if the taxpayer:

(i) Seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under IRC § 6662 at the time the taxpayer requests relief (taking into account any qualified amended return filed within the meaning of Treas. Reg. §1.6664-2(c)(3) and the new position requires or permits a regulatory election for which relief is requested;

(ii) Was informed in all material respects of the required election and related tax consequences, but chose not to file the election; or

(iii) Uses hindsight in requesting relief. If specific facts have changed since the due date of making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

[C] Extensions to pay

[1] Generally as to extensions to pay

As stated previously, unless an extension to pay is filed with the extension to file, the tax is due on the regular due date for the return. Several extensions are available to pay estate taxes.

[a] Application

The application for an extension of time to pay must be in writing, state the period of the extension request, and include a declaration that is made under penalties of perjury. More requirements are set forth in Treas. Reg. §20.6161-1(b).

[b] When filed

According to the Instructions to Form 4768, an application for an extension of time to pay estate tax received after the estate tax due date will not be considered by the IRS, except for certain IRC § 6166 elections as to closely held business.

[2] Reasonable cause

For reasonable cause, the IRS can grant an extension of up to 12 months to pay the estate tax. IRC § 6161(a). Treas. Reg. §20.6161-1(a)(1). It is relatively easy to get this extension.

[3] Undue hardship

For undue hardship, the IRS can extend payment of the tax due for a reasonable period of up to 10 years after the due date. IRC § 6161(a)(2). Treas. Reg. §20.6161-1(a)(2).

Undue hardship is not to be granted upon a general statement of hardship or merely upon a showing of reasonable cause, and it means more than an inconvenience to the estate. Undue hardship can come from raising funds from other sources than a farm or closely held business or the assets to be liquidated can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due. Treas. Reg. §20.6161-1(2)(ii).

Document 3 - Letter to Client with Application for Extension

September 1, 2003

Mr. Richard V. Sample
1313 Ruele
San Antonio, Texas 78299

Re: Estate of John Q. Sample

Dear Mr. Sample:

Enclosed please find a Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, which needs to be signed by you before we can submit it to the Internal Revenue Service.We do not anticipate any problem in obtaining the extension, because you are paying all of the estimated tax due. If the final amount of tax paid when the return is filed is greater than this payment, then the estate must pay interest on the amount of the underpayment. The federal interest rate is currently _____%, and it may adjust for the quarters beginning July 1 and October 1. The State of Texas charges 10% per annum, compounded annually, on underpayments. For overpayments, the Internal Revenue Service pays the same interest rate as for underpayments, but the State of Texas does not pay any interest for overpayments. Please sign and date the enclosed documents where indicated and return them to me along with the checks for the amounts indicated by the morning of September 30, 2003, so they can be filed that day. (The extension request to the State of Texas does not require your signature, but a copy of the signed federal request will be included.)The federal extension request will be filed in person with the IRS office in San Antonio, and the State request will be mailed that same date. If you want the float on the tax, the checks should be written on a checking account that pays interest, but there should be a sufficient balance in the amount to cover the checks on the due date. Please let me know if you have any questions regarding the enclosed.

Sincerely yours,

Glen A. Yale

[4] Installment payment due to closely held business

This is more extensively discussed below.

[5] Future reversion or remainder property

IRC § 6163 permits tax attributable to a future reversion or remainder property interest to be postponed until six months after the termination of the preceding interest. Because of the bond requirement, discussed below, this extension may be of limited usefulness.

[D] Installment payment due to closely held business, Section 6166.

IRC § 6166 allows special installment payment relief whenever a closely held business interest represents 35 percent or more of the value of the decedent's estate. The section helps prevent the

necessity of selling the business in order to raise funds to pay the estate tax.

The estate tax attributable to the business interest can be paid in 10 equal annual installments beginning on the fifth anniversary of the due date of the estate tax return. Interest is due annually on the due date with the first payment due on the first anniversary of the return due date. The IRC sends a notice of installment due about a month before each due date.

[1] Active trade or business

Separate businesses can be aggregated to meet the 35 percent test as long as the decedent's estate includes more than 20 percent of each separate business. FLRs 9250022, 9602017, and 199929025. Several revenue rulings address what constitutes an active trade or business: Rev.Rul. 75-365, 1975-2 CB 471; Rev. Rul. 75-366, *Id*. 472; Rev. Rul. 75-367, *Id*.; and Rev. Rul. 75- 401, *Id*. 473. In TAM 9403004 the IRS ruled that leasing real estate to a corporation was not an active trade or business.

[2] Interest pre-1998 law

For decedents dying before January 1, 1998, interest of four percent is payable with respect to the deferred tax on the first $1 million in value of a decedent's business, while interest on the balance of the deferred tax is at the current rate. With the $600,000 exemption taken into account, the four percent rate applies to the deferred tax on no more than $400,000 of value. The decedent's estate is also permitted to deduct the interest as an administration expense when paid, requiring a recalculation of the estate tax every year.

[3] Interest post-1997 law

For decedents dying after December 31, 1997, interest at the rate of two percent will be charged on the tax attributable to the first $1 million in value of the business, and at a rate equal to 45 per cent of the current rate on the balance of the deferred tax. The two percent rate will apply to the tax on $1 million in value of the business without reduction for the exemption. The trade off for the reduced interest rates, the estate will no longer be permitted to deduct the interest for either estate or income tax purposes. This change comes from the Taxpayer Relief Act of 1997.

The $1 million in value on which tax is deferred at the favorable rates will be adjusted annually in $10,000 increments for any increase in the cost of living occurring after 1997.

[4] Election for pre-1998 estates

The new interest rules can apply to the remaining estate tax deferred by estates of decedents dying before 1998 if the personal representative irrevocably elects to do so before January 1, 1999. The two percent rate only applies to the four percent portion under the prior law.

[5] Election

The election is made on a timely filed, including extensions, estate tax return. The election cannot be made on a late filed return. The election can be make or to a deficiency assessed on audit on a late filed return according to TAM 84432007, but that advice is not precedent and the election might not be available in a particular estate where there is a late filed return.

[6] Declaratory judgment for qualification

Under the Taxpayer Relief Act of 1997, an estate, as to which the IRS has denied the right to defer tax, may petition the Tax Court for declaratory judgment that it is so entitled. This applies to estates of decedents dying after date of enactment of the Taxpayer Relief Act of 1997, August 5, 1997.

[7] District court jurisdiction

Under previous law before the Internal Revenue Service Restructuring and Reform Act of 1998, the district courts and the Court of Federal Claims did not have jurisdiction over claims for refunds by taxpayers deferring estate tax payments under IRC § 6166 unless the entire estate tax liability had been paid. Timely payment of the installments due before the bringing of the action was insufficient to invoke jurisdiction.

After the Internal Revenue Service Restructuring and Reform Act of 1998, IRC § 7422(j), the district courts and the Court of Federal Claims will have jurisdiction over an action brought by the representative of the estate to determine the correct amount of the estate's liability or for any refund of the estate's estate tax liability, even when the full amount of the tax liability has not been paid because of an IRC § 6166 election, if as of the date the action is filed:

(i) no part of the installments have been accelerated (due to late payment);

(ii) all installments due before the date the action is filed, as well as all non-deferred estate taxes due, have been paid;

(iii) (there is no case pending in the Tax Court with respect to the estate tax imposed on the estate; and if a notice of deficiency with respect to the estate tax has been issued, the time for filing a Tax Court petition with respect to the notice has expired;

(iv) no proceeding for declaratory judgment under IRC § 7479 is pending.

[8] Bond

IRC § 6165 authorizes conditioning the deferral under IRC § 6166 upon the taxpayer furnishing a

bond not exceeding double the amount with which the extension is granted. If a lien is granted under IRC § 6324A, the bond under IRC § 6165 cannot be required.

[9] Special lien on section 6166 deferral

IRC § 6324A provides a special lien for estate tax deferred under IRC § 6166. This lien is in lieu of both the IRC § 6165 bond and the IRC § 6324 lien.

The Service may request a lien on property the value of which does not exceed the sum of the deferred amount and the required interest amount. Value of the property is determined as of the date the estate tax is due without extensions, IRC §s 6151(a) and 6324A(b)(2), which will be the date nine months after the death of the decedent. Any liens under IRC § 6324B, which are special liens as to real property on which the IRC § 2032A special use election is made, are to be taken into account in valuing the property subject to the lien. IRC § 6324A(b)(2).

Each person with an interest, whether or not in possession, in the property subject to the lien must sign a written agreement consenting to the creation of the lien with respect to such property. IRC § 6324A(c). The agreement must also designate a responsible person who shall be the agent for the beneficiaries of the estate and the persons who have consented to the creation of the lien in any dealings with the Service with regard to matters arising under IRC §s 6166 or 6324A.

The property subject to the lien may be real and other property that can be expected to survive the deferral period, which is the period for which the tax is deferred under IRC § 6166. IRC § 6324A(b)(1) and (e)(3).

To be valid as against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor, a notice of the lien meeting the requirements of IRC § 6323(f) must be filed according to IRC § 6324A(d)(1).

This lien is to arise when the executor is discharged from liability under IRC § 2204 or if earlier at the time the notice (mentioned in the previous paragraph) is filed and continues until the liability for the deferred amount is satisfied or the liability becomes unenforceable by reason of the lapse of time. IRC § 6324A(d)(2).

If the amount of the deferred amount and the required interest amount exceeds the amount of the property subject to the agreement, the Service may accept a bond in the amount of the difference conditioned on payment of the amount deferred. IRC § 6324A(b)(3). This bond is on the amount of the difference and not double the amount as provided in IRC § 6165.

If the value of the property subject to the lien falls below the sum of the deferred amount and the required interest amount, then the Service can require that additional property be made subject to the agreement for the amount of the difference. If additional property is not posted within 90 days of notice by the Service, then the failure to post the additional amount shall be treated as an act accelerating payments under IRC § 6166(g). IRC § 6324A(d)(5).

For a case where the Section 6324A lien attached to stock in a closely held company and the assets of the company were sold, making the stock worthless, see *Gary Skiba v. IRC (In re Robert Q. Roth)* 2004 TNT 15-8 (Bankr. Ct. W.D. Pa.), in which the court ruled that the lien did not attach to the proceeds of the sale but instead became an unsecured claim in bankruptcy.

[E] Difference in payment

If the tax paid with the return is different from the balance due or figured on the return, the difference should be explained in an attached statement. Instructions, p.2.

[F] Partial payments

The IRS has provided rules governing the application of partial payment of tax, penalty and interest in Rev.Proc. 2002-26, 2002-1 CB 746. If additional taxes, penalty and interest have been assessed against a taxpayer and the taxpayer provides specific written directions as to how a partial payment is to be applied, the IRS will apply the payment in accordance with such directions. If the taxpayer does not provide written directions, the IRS will apply the payment to periods in the order of priority that the IRS determines will serve its best interest and will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. Within a given period, it will be applied to tax, penalty and interest in that order until the amount is absorbed.

[G] When filed

Because of the time value of money, taxes should not be paid until due. A return should also not be filed until due because changing fact situations may change the best way to file the return. For example, death of the surviving spouse within the maximum period of time to file the return of the first to die may affect the amount of marital deduction to elect on the first return because of the credit on previously taxed property.

[H] Overpayments and interest

Estate tax overpaid on an extension will be refunded once the estate tax return is filed showing a lower federal estate tax liability. Interest due to overpayment of estate tax will be paid on the overpaid amount from the due date, disregarding extensions until the refund date, IRC § 6611,

however, no interest is payable if the refund is due to certain credits, such as the state death tax credit, IRC § 2011(c), and the foreign tax credit IRC § 2014(c). IRC § 6612(c). Rev. Rul. 61-58, 1961-1CB 414, provides that a refund based partially on credit for state inheritance taxes and partially on other adjustments will bear interest only on that potion of the refund attributable to adjustments other than the credit for state inheritance taxes.

[I] Attachments

If an extension to file or an extension to pay was granted, a copy of the approved Form 4768 is to be attached to the Form 706 when filed. Instructions, p. 2.

[J] Security

The IRS can require the posting of a bond (not to exceed double the amount extended) when any extension of time to pay any tax is granted. IRC § 6165. The requirement of a bond may effectively be a denial of the extension request because of the difficulty in finding a bond acceptable to the IRS, in finding a bonding company willing to post the bond, in finding a bond with acceptable premiums, or in finding it worth while overall to go through the hassle of posting a bond. Any amount deferred under IRS Section 6166 can be subject to a lien under IRC 6324A.

[K] Extend probate inventory

The probate inventory in Texas is due 90 days after qualification of the personal representative, prior to the due date for filing the Form 706. Because on an audit the IRS may review the inventory, the better practice is to make sure the inventory and the Form 706 are consistent and file a motion to extend the filing of the inventory until 30 days after filing the Form 706. To the extent the law of the state of decedent's domicile permits filing a probate inventory after the estate tax return is filed, take advantage of that procedure because on audit the IRS examiner will review any probate inventory.

[L] Equitable recoupment

Under the doctrine of equitable recoupment an estate may be entitled to a credit for income tax overpaid by a residuary legatee on gains recognized on the sale of stock where the date of death value was greater than that reported by the estate. In *Estate of Frank Branson v. Comm.*, 88 AFTR2d Par. 2001-5272 (9th Cir. 2001) the executor and beneficiary sold closely held stock of the estate and paid a capital gains tax. Later the value of the stock was adjusted upward and the estate had an estate tax deficiency, which it wanted to satisfy in part with the beneficiary's overpayment of income tax, which was now barred by the statute of limitations. The Circuit Court agreed with the Tax Court, 113 TC No. 2 (July 13, 1999), and stated the criteria for equitable recoupment:

> First, the same "transaction, item or taxable event" must be subject to two taxes. Second, the taxes must be inconsistent in that the Tax Code authorizes only a single tax. *See Bull*, 295 U.S. at 256 (same funds cannot be taxed both as an asset of the estate and income to the estate); *Dalm*, 494 U.S. at 596 (single item cannot be subject to both gift tax and income tax). Third, the tax sought to be recouped must be time barred. *Stone v. White*, 301 U.S. 532, 538 (1937); *Kolom v. United States*, 791 F.2d 762, 767 (9th cir. 1986) (overruled on other grounds, *Dalm* 494 U.S. 596 (1990)). Fourth, there must be an "identity of interest" between the parties paying the duplicative tax. *Stone*, 301 U.S. 532 (trustee who paid erroneous tax has sufficient identity of interest with beneficiary who owed tax deficiency).

The court found that the single transaction requirement was met where the same stock is taxed as both the corpus of the estate and income to the beneficiary.

§1.13 *How paid*

The tax is to be paid at the time and place for filing the return. IRC § 6151. The tax is paid by check or money order payable to "United States Treasury" Instructions, p.2, and the Service requests that the check include the decedent's name, social security number and "Form 706." The IRS may accept payment by a credit card or debit card. IRC § 6311(d)(3); Temp. Treas. Regs. §301.6311-2T. A difference between the amount paid and the tax due as shown on the return should be explained in an attached statement.

Your author has heard that other preparers have accidentally sent a check made payable to the state tax authorities and in the amount owed to the state to the IRS and the check is negotiated by the IRS. The converse is true. The check made payable to the IRS and in the amount owed to the IRS is accidentally sent to the state tax authorities and the state authorities negotiate the check. If one goes back through the federal reserve to get the check reversed, then one has made no payment on the tax. Make sure the correct check goes with the return.

Under Treas. Reg. §301.7502-1(b)(3) a payment by check is timely only if the check is honored upon presentation.

[A] Installments

A district director, director of a service center, or a director of a compliance center is authorized to enter into a written agreement allowing payment of taxes on an installment basis if it is determined that the agreement will facilitate collection. IRC § 6159(a); Treas. Reg. §301.6159-1(a).

[B] Extensions to pay

Extensions to pay are further discussed above.

[C] Electronic transfer

The tax may also be paid by electronic transfer. IRC § 6302(h); Treas. Reg. §20.6302-1. The author questions the benefit of electronic transfer when the tax is paid when due.

§1.14 *Liens*

[A] General lien

IRC § 6321 provides that if any person liable for any tax neglects or refuses to pay after demand, the amount of the tax plus any interest, additional amount, addition to tax, assessable penalty, or costs that may accrue, shall be a lien in favor of the United States upon all property and rights to property belonging to that person. This lien arises only after a tax has been assessed and demand for payment made. The lien attaches to all property, including property acquired after the lien arises. Treas. Reg. §301.6321-1.

[B] Special estate tax liens

The estate tax, until paid or until it becomes unenforceable by reason of the lapse of time, becomes a lien upon the gross estate of the decedent for 10 years from the date of death. IRC § 6324. The regulations state that the lien attaches at the date of the decedent's death to all property in the gross estate, regardless of whether or not the property comes into the possession of the duly qualified executor. Treas. Reg. §301.6324-1(a)(1). No notice of lien need be filed for this lien to attach.

The property in the gross estate used for the payment of charges against the estate and expenses of administration, allowed by any court having jurisdiction, is divested of the lien. *Id*. The regulations do not clarify how the lien is divested when claims may be properly paid without court approval or where property within a trust not subject to court supervision discharges such claims.

The lien is also divested on property included in the gross estate under IRC §s 2034 to 2042 inclusive that is transferred by, or transferred by the transferee of, the spouse, transferee, trustee, surviving tenant, person in possession of the property by reason of the exercise, non-exercise, or release of a power of appointment, or beneficiary to a purchaser or holder of a security interest. The lien then attaches to all of the property of the spouse, transferee, trustee, surviving tenant, person in possession, beneficiary, or transferee of any such person, except the property transferred to the purchaser or a holder of a security interest. Treas. Reg. §301.6324-1(a)(2)(ii).

The regulations also contain a curious provision divesting the lien from that portion of the gross estate transferred to a purchaser or holder of a security interest, if the entire tax is paid pursuant to a request by the executor for discharge from personal liability. This is curious because the lien would be divested because of payment of estate tax. The lien then attaches to the consideration received by the purchaser or holder of the security interest. Treas. Reg. §301.6324-1(a)(2)(iii).

The special lien will also be divested on property as to which the district director has issued a certificate releasing a lien under IRC § 6325(a) and its regulations. Treas. Reg. §301.6324-1(a)(2)(iv).

The regulations under this special lien section make it clear that the IRC § 6324 special lien and the IRC § 6321 general lien are not mutually exclusive, but rather cumulative. The special lien may exist while the general lien does not, the general lien may exist while the special lien does not, and the special and general liens may exist simultaneously, depending upon the facts. Treas. Reg. §301.6324(d).

[C] Special lien on section 6166 deferral

IRC § 6324A provides a special lien for estate tax deferred under IRC § 6166. This is discussed above.

[D] Special lien on special use property

IRC § 6324B provides a special lien on property on which special use valuation under IRC § 2032A has been elected. This is discussed in Chapter 5, "Schedule A-1 –Section 2032A Valuation.

[E] Liens on homestead

A residence or farm in decedent's estate may be subject to homestead rights under state law in favor of the decedent's spouse or minor children. Under the Supremacy Clause of the Constitution, a homestead may be encumbered by a Federal tax lien. *Crowder v. Benchmark Bank*, 919 S.W.2d 657, 660 (Tex. 1996) (as to Texas homestead rights); *Frappier v. Texas Commerce Bank, N.A.*, 879 F.Supp. 715 (S.D. Tex. 1995).

§1.15 *Penalties*

[A] Late filing or payment and interest

As discussed above, in the subsection entitled "Late payment penalty," IRC § 6651 provides penalties for late filing and for late payment of tax unless there is reasonable cause for the delay. The late filing penalty will not be imposed if the taxpayer can show that the failure to file a timely return is due to reasonable cause. Executors filing late should attach an explanation to the return to show reasonable cause. Instructions, p.3. Late payment will always include interest; see the subsection above entitled "Interest on unpaid tax."

[B] Willful failure to file

IRC § 6651(f) provides for increased penalties if the failure to file or pay is fraudulent.

[C] Undervaluation

IRC § 6662(e)(2) provides a 20% penalty for the underpayment of estate tax of $5,000 or more when the underpayment is attributable to valuation understatements. A valuation understatement occurs when the reported value of property is 50% or less of the actual value of the property. The valuation understatement penalty increases to 40% if there is a gross valuation understatement, which occurs if any property on the return is valued at 25% or less of the value determined to be correct.

[1] Understatement of income tax

The IRC § 6662(d)(2) penalty also applies to an understatement of income tax where the understatement is due to overstating an asset's value on an estate tax return and overstating the basis on the asset. Basis is discussed below.

[2] Avoiding the penalty

The understatement penalty can be avoided by acting in good faith in the reporting of the item if (1) there is or was substantial authority for such tax treatment by the taxpayer or (2) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of such item by the taxpayer. IRC § 6662 (d)(2)(c).

The regulations under Section 6664 primarily address undervaluation for income tax purposes and at no time specifically addresses understatement for estate tax purposes.

> (b) *Facts and circumstances taken into account*—(1) *In general*. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.…Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.
>
> Treas. Reg. §1.6664-4(b)(1)

The regulations address advice from professionals in general.

> (c) Reliance on opinion or advice—(1) Facts and circumstances, minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.
>
> (i) All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances.…In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.
>
> (ii) No unreasonable assumptions. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true…
>
> Treas. Reg. §1.6664-4(c)(1)

Specific mention of reliance on appraisals is brief.

> Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of the property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used.

Treas. Reg. §1.6664-4(b)(1)

In *Estate of Thompson v. Comm.*, 88 TCM 48 (2004), the Tax Court addressed the accuracy-related substantial understatement penalties on an estate tax valuation understatement based upon an appraisal of a closely held business interest. The taxpayer's value was $1.75 million, the Service's expert arrived at the value of $32.4 million, and the court determined the value to be $13.5 million. There were facts regarding the appraiser and the appraisal unfavorable to the estate. The company was located in New York City, yet the estate hired an attorney who lived in Alaska to appraise the interest. The New York State surrogate's court granted the attorney limited estate administrative powers to represent decedent's estate in connection with the anticipated audit of the estate tax return and handling the anticipated negotiations with the Service over the value. The estate acknowledged that it hired the Alaska attorney, whom the family learned about from an attorney for the decedent's family who had met the Alaska attorney on a fishing trip, to have the audit conducted in Alaska where the attorney believed and apparently represented to the estate's representative that he would be able to obtain a more favorable valuation of the stock. The Tax Court noted that the Alaska attorney "impressed us as too inexperience, accommodating, and biased in favor of the estate" while the Service's expert "appears to have selected his comparable companies in a casual manner… made significant errors in his calculations and analysis, and he made questionable and inadequately explained adjustments.…" Although this was an estate tax case, the court referenced the income tax regulations under Section 6664 without comment as to their application to estate taxes. The court concluded it was inappropriate to impose the accuracy-related penalty, because the valuation was particularly difficult and unique; comparable companies were not found; valuation of the interest under the capitalization of income and under the discounted cashflow methods involved a number of difficult judgment calls; the Service's estate made significant errors in his various calculations; the evaluation of intangible risks and opportunities as to the Internet was difficult and imprecise; while the experts for the estate were aggressive in their relatively low valuation of the interest, the Service's expert was aggressive in a relatively high valuation; and the court's valuation was closer to the estate's valuation than to respondent's valuation.

The imposition of accuracy-related negligence penalties were at issue in the notable case of *Estate of Schauerhamer v. Comm.*, TC Memo 1997-242, in which partnerships were disregarded and the underlying assets were included in the gross estate under IRC § 2036(a) because decedent retained enjoyment of the transferred assets; decedent and her family had an implied understanding that she would retain economic benefits post-transfer; and the decedent used partnership income, which she deposited in her personal bank account for her personal benefit. The court held the estate was not liable for the accuracy-related penalty for negligence because the estate acted reasonably and in good faith in relying on the advice of tax professionals and property appraisers.

In *Sammons v. Comm.*, 838 F.2d 330 (9th Cir. 1988), the court said that reasonable reliance on an appraisal avoids the negligence penalty. The case involved the proper income tax charitable deduction allowed on a donation of American Indian artifacts to a museum. The taxpayers paid $140,000 for a collection of artifacts from a dealer that paid $60,000 for it. The priest who founded the museum advised the taxpayers that the entire collection had a fair market value in excess of $500,000. The collection was appraised at $540,185 and $548,380. The Tax Court found that an appraisal of $422,440 was performed by exceptionally well qualified appraisers. Because negligence within IRC § 6653(a) [now IRC § 6662] is measured by the "reasonable, prudent person" standard, the IRS argued that because the taxpayer was a successful and sophisticated businessman, he should have known that it was unreasonable to claim a deduction in an amount that far exceeded the cost of the donated items, especially when the items had been held for such a brief period, nine months, before the contribution was made, and the taxpayer argued that the claimed deduction was not unreasonable because a reasonable and prudent person is entitled to rely on an expert appraiser's valuation of an art collection. The circuit court found that the taxpayer's reliance on a $548,380 appraisal was at least "reasonably debatable" and the IRC § 6653(a) [now IRC § 6662] negligence penalty was improperly assessed. The court then found that this was in accordance with what the Tax Court has previously held:

> This conclusion accords with cases decided by the Tax Court. In *Biagiotti v. Commissioner*, the Tax Court found that although the taxpayers' expert appraiser's report was not entitled to any probative weight in determining the fair market value of a collection of Pre-Columbian artifacts, imposing a negligence penalty was inappropriate because the taxpayers had no reason to question their expert's ability or reliability. [FN3:In *Biagiotti*, the taxpayers relied on a valuation report prepared by an appraiser whose reputation for credibility and reliability was less than pristine. See, 52 TCM (CCH) at 590. The taxpayers, however, had no reason to suspect that their expert routinely prepared inflated valuation reports. *See id*. at 595.] *Biagiotti v.*

Commissioner, 52 TCM (CCH) 588, 595 (1986). Indeed, the Tax Court in *Biagiotti* specifically stated that "the difference between [the taxpayers'] cost and [their expert's] appraised value does not necessarily indicate that [the taxpayers] knew or should have known the appraisals were inflated." *Id*. Similarly, in *Broad v. Commissioner*, 52 TCM (CCH) 12 (1986), and *Lightman v. Commissioner*, 50 TCM (CCH) 266 (1985), the Tax Court reversed the Commissioner's imposition of a negligence penalty when the taxpayers reasonably relied on an expert's valuation of donated property that was subsequently rejected by the Tax Court. "Nothing in the record indicates [the appraisals] were not made in good faith and justifiably relied on by the [taxpayers]." *Lightman*, 50 TCM (CCH) at 271. When a taxpayer exercises due care in obtaining an appraisal of fair market value, *Biagiotti*, 52 TCM (CCH) at 595, and the taxpayer presents "some proof" in support of the asserted fair market value, reasonable reliance on a valuation report does not amount to negligence. See *Broad*, 52 TCM (CCH) at 15.

Reasonable reliance on an appraisal may avoid negligence, but if there is a potential question, then prepare a documented determination as to why reliance is reasonable.

Estate of True v. Comm., TC Memo 2001-167, imposed the undervaluation penalty after finding that the taxpayers did not act in good faith. On gift tax returns subject to review upon the taxpayer's death, the decedent did not engage a professional appraiser to value the transferred interests in partnerships. On the estate tax return the decedent's closely held companies were reported as cash in his living trust because under buy-sell agreements the sales were deemed to have been transacted as of the day before decedent's death. The estate hired an appraiser and instructed him to disregard book values, yet most of his values were approximately book value. Two of the book values were less that 20 percent and 30 percent of the appraiser's value, yet the estate used book value. The reasonable cause exception to the accuracy-related penalties did not apply as the facts of record indicated that the estate did not exercise ordinary business care and prudence in attempting to assess the proper estate and gift tax liabilities. The decedent and his personal representatives had substantial sophistication in legal, valuation, and tax matters; and they were accustomed to working with and using lawyers on both tax and non-tax matters. They did not rely on professional appraisals or obtain professional advice. This case suggests that it may be an open question whether the determination whether the percentage threshold for a substantial or gross valuation understatement had been reached is made on a property-by-property basis.

[D] Civil fraud

IRC § 6663 imposes a penalty of 75% on any tax that is underpaid due to fraud. If the IRS establishes, by clear and convincing evidence, that any portion of an underpayment is attributable to fraud, then the entire underpayment is treated as attributable to fraud, except with respect to any item that the taxpayer establishes, by a preponderance of the evidence, is not attributable to fraud. The burden of the IRS is set forth in the Revenue Reconciliation Act of 1989. If the IRC § 6663 penalty is imposed, then there is no accuracy related penalty imposed under IRC § 6662.

In *Trompeter v. Comm*., 111 TC No. 2 (1998), the Tax Court held that in determining the 75% fraud penalty against the estate under IRC § 6663(a) that the estate's underpayment is determined by taking into account all deductible expenses, including the expenses paid or incurred after filing the return. The estate deducted trustees' fees, attorneys' fees, and deficiency interest. When the estate tax is 50% and the penalty adds another 37 ½ %, every dollar of deduction will be worth 87 ½ cents in less assessment, before interest. It would not necessarily require an extreme set of facts in which one dollar of deductible expense could save more than that in IRS assessment.

In *Trompeter v. Comm*., No. 279 F.3d 767 (9th Cir. 2002), which was the appeal of the Tax Court decision, the appeals court vacated the Tax Court's findings as to omitted assets and closely held stock and asked the Tax Court to consider whether it was necessary to revisit its conclusions regarding fraud, but rejecting the Estate's argument that reliance on an appraisal from an accountant avoids fraud.

> In particular, we reject the Estate's suggestion that blind reliance on an accountant's valuation is sufficient per se to avoid fraud. Indeed, were that the case, experts for hire would serve as an ironclad defense in tax fraud cases. Although it may be reasonable in some circumstances for a taxpayer to rely on an accountant's advice about the intricacies of tax law, see e.g., *United States v. Boyle*, 449 U.S. 241, 251 (1985), that presumption only attaches to valuations when the taxpayer "exercises due care in obtaining an appraisal of fair market value" and presents "some proof in support of the asserted" valuation. *Sammons. Comm'r.*, 838 F.2d 330, 337 (9th Cir. 1988) (internal quotation marks and citations omitted). Here, the Tax Court appropriately noted that Trompeter's daughters are well-educated, sophisticated, and knowledgeable about various of the Estate's holdings, and thus should not have blindly accepted expert conclusions at face value – especially when those conclusions may have

been contradicted by other appraisals prepared by the Estate. *Id*.

Compare this case to *Sammons v. Comm.*, 838 F.2d 330 (9th Cir. 1988), where reasonable reliance avoided the negligence penalty. In *Trompeter v. Comm.*, 111 TC No. 2 (1998), at the trial level, it was clear that the executor's reliance on the accountant's valuation of closely held stock was not reasonable and the executors failed to exercise due care. The return valued preferred stock at $15,335 when the court's determination was $2,708,536.

On remand, the Tax Court in TC Memo. 2004-27, No. 11170-95, addressed its previous finding of fraud.

> Pursuant to the direction of the Court of Appeals for the Ninth Circuit, we now consider whether it is appropriate to revisit our conclusions as to fraud. We do not believe it is. Although the Court of Appeals for the Ninth Circuit has not asked us to restate the legal basis for our finding of fraud, and thus we do not, we emphasize our belief that the coexecutors' willing and conscious failure to disclose to respondent the assets of the estate, coupled with their deliberate undervaluation of some of the assets which were disclosed to respondent, constitutes clear and convincing evidence of fraud deserving of the section 6663 penalty.

[E] Criminal fraud

Several provisions of the IRC make failure to file a properly prepared estate tax return a criminal offense. IRC § 7201 is the tax evasion provision applicable to federal taxes in general and thus also applicable to estate taxes.

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

This provision addresses willful evasion. The few reported cases dealing with willful evasion of estate tax make interesting reading in the brazenness of the fiduciary's conduct and in figuring how the fiduciary became the subject of IRS interest.

U.S. v. Alker, 255 F.2d 851 (3rd Cir. 1958, cert. denied 79 S.Ct. 41), a criminal case, dealt with an executor charged under Section 894(b)(2)(C), Internal Revenue Code of 1939, precursor to IRC § 7201, with attempting to evade part of the estate tax due. The government alleged that the day after the decedent died, the executor removed $35,000, in seven packages of money, belonging to decedent from decedent's safe in the presence of four beneficiaries under the will. The executor did not report this money in the estate tax return as part of the assets of the estate. The Circuit Court affirmed the conviction under which the executor was sentenced to six months imprisonment and fined $8,000. Apparently, at least one of the beneficiaries turned in the executor; one of the prosecution witnesses was present at the opening of the safe. Your author speculates that it was not the fraud directed at the IRS alone that motivated the beneficiary to report the executor, but the fraud was also directed at the beneficiaries.

In *U.S. v. DeNiro*, 392 F.2d 753 (6th Cir. 1968), which could be an episode of *The Sopranos*, three brothers appealed convictions for conspiracy and attempted evasion of federal estate taxes on the estate of their deceased brother, operator of a numbers business, who met his demise when endeavoring to start his automobile he detonated a bomb attached to the ignition switch. He died intestate, his heirs being two children by his former wife, but there was no probate due to his having no assets recorded in his own name. Through use of "nominees and straws to conceal his ownership of property," decedent left a gross estate of $311,047 and a net taxable estate of $215,816 upon which the estate tax liability was $55,445, as found by the court. The government's theory, developed from an investigation of one brother's failure to file income tax returns, was that the brothers, in concert, took possession and appropriated decedent's assets to exclusion of his lawful heirs, concealing the assets and obstructing an investigation by the IRS by giving false statements that decedent left no estate and they had no assets, all to evade payment of federal estate taxes. In defense on appeal the brothers argued that they did not willfully evade estate taxes and if they were guilty of an attempt to defraud the true heirs (they did not admit this), there was no purpose to evade federal estate taxes. The brothers argued that none graduated from high school and the court acknowledged that "The gravamen of Section 7201 is the specific intent to deprive the Government of taxes." Unfortunately for the brothers three, the IRS agent told each brother of the federal estate tax and consequence of evasion. This appears to be an instance in which the government went after the brothers under IRC § 7201 because of an initial focus on them as mobsters.

IRC § 7202 has some overlap with Section 7201 when it is recognized that the "person required" is the executor.

> Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by

law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

IRC §s 7201 and 7202 are felony provisions dealing with commissions, while IRC § 7203 is a misdemeanor provision addressing omissions, indicating that it is better to accrue an omission rather than commit a commission.

SEC. 7203. Any person required under this titled to pay any ... tax, or required by this title or by regulations made under authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such ... tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than $25,000 ($1000,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution.

Section 7206. Any person who–

(1) DECLARATION UNDER PENALTIES OF PERJURY.--Willfully makes and subscribed any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) AID OR ASSISTANCE.--Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; or

(3) FRAUDULENT BONDS, PERMITS, AND ENTRIES.--Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws, or by any regulation made in pursuance thereof, or procures the same to be falsely or fraudulently executed, or advises, aids in, or connives at such execution thereof; or

(4) REMOVAL OR CONCEALMENT WITH INTENT TO DEFRAUD.--Removes, deposits or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed, or any property upon which levy is authorized by section 6331, with intent to evade or defeat the assessment or collection of any tax imposed by this title;

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

The CCH notations state that the maximum fine may actually be $250,000. 18 U.S.C. §3571(b)(3) states the maximum penalty imposed for a felony is $250,000 while 18 U.S.C. §3571(e) provides that the fine limits imposed under that section are applicable unless a statute setting forth a lesser fine includes language specifically exempting it from the fine otherwise applicable under §3571. IRC § 7206 contains no limiting language and hence the penalty under §3571 overrides the penalty imposed by IRC § 7206.

U.S. v. Hooks, 88-1 USTC 84,175 (7th Cir. 1988) affirmed a conviction for aiding in the filing of a false estate tax return in violation of IRC § 7206(2) and conspiracy to defraud the United States in violation of 18 U.S.C. §371 where the evidence established that Hooks received from decedent's widow, Hooks' mother-in-law, ten bearer bonds worth approximately $375,000 that should have been turned over to the tax preparer; that Hooks hid these bonds in his employer's bank safe deposit box; that he later cashed the bonds with the aid of his co-defendant, a bank officer, in such a way that they could not be traced back to him or the estate. It is unclear how the IRS was alerted to Hooks, because he was not the executor nor the preparer. But, there were statements by Hooks that he was trying to keep the bonds out of a $10 million estate, and he created bad facts for himself in spending the proceeds on a down payment on an airplane, two pieces of art by Chagall and a condominium.

§1.16 *Estate tax liens*

[A] Upon death

Under IRC § 6324, upon death, a lien attaches to the decedent's gross estate for 10 years. The lien dissolves:

(i) when the estate tax is paid in full;

(ii) when the estate tax becomes unenforceable by reason of the lapse of time;

(iii) as to that part of the gross estate used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction.

Exception (i) is the reason for filing a copy of the closing letter in the probate file. A sample filing is set forth in Chapter XXV, entitled "Closing Letters and Closing Agreements." Query whether exception (iii) applies to an independent administration in Texas.

To the extent the estate tax is not paid when due, then a transferee of property included in decedent's estate, to the extent of the value of the property on decedent's death is personally liable for the tax.

This lien is also not discharged by the IRC § 2204 discharge of fiduciary from personal liability (discussed below) shall not operate as a release for any deficiency that later may be determined to be due.

[B] Upon demand for tax payment

If the executor (or other person responsible for payment of the tax) fails to make payment upon demand, a lien attached upon all property and rights to property, real or personal, belonging to the executor. This lien is for the amount of tax, interest, additional amount, addition to tax, accessible penalty, and additional costs. IRC § 6321.

§1.17 *Deficiencies*

[A] General three-year rule

Under IRC § 6501(a), a deficiency must be assessed or a statutory notice of deficiency must be mailed within three years of the later of the date of filing the Form 706 or the due date of the return with extensions. This time limit cannot be extended by agreement of the taxpayer and the IRS. IRC § 6501(c). In the event that no return is filed or the IRS takes the position that the document filed is not a return, the statute of limitations never runs.

[1] Suspension of three-year rule

Under IRC § 6503(a)(1), the period of limitations on assessment and collection of a deficiency is suspended for 90 days after a notice of deficiency is mailed. The limitations is further suspended once a proceeding regarding the deficiency is placed on the Tax Court docket and until sixty days after the decision becomes final. For a case where the period of assessment for a decedent who died on December 4, 1981, did not expire until March 2, 1997, see, *Edward Fridovich v. Comm.*, TC Memo 2001-32.

[B] False or fraudulent returns

For a false or fraudulent return prepared with the intent to evade tax, the assessment may be made or a notice of deficiency mailed at any time. IRC § 6501(c)(1).

[C] Omissions

A six-year period applies in the case of an estate tax return that omits from the gross estate items includable in such gross estate representing more than 25% of the gross estate stated on the return. Items disclosed in the return or an attached statement in a manner adequate to apprise the IRS of the nature and amount of such item are disregarded in determining the items omitted from the gross estate. IRC § 6501(e)(2). This rule is stated in terms of assets and not in terms of overstating deductions.

A statutory notice of deficiency issued to a decedent's estate more than three years after the estate tax return was filed was barred by the statute of limitations in *Estate of Helen G. Williamson v. Comm.* 72 TCM (CCH) 687 (1996). The tax court held that IRC Sec. 6501(e)(2) six year statute of limitations was applicable to an estate tax return that omits items from the gross estate that exceed 25 percent of the gross estate reported on the estate tax return. As a taxpayer favorable opinion, the specific findings of the tax court bear close examination. *Id*. at 690.

> In this case, the application for extension of time to file the estate tax return included a written statement as to the reasons for requesting the delay: that because of a dispute between decedent's estate and her surviving husband, the estate was unable to list and value the items of the estate that should be returned. When the Federal estate tax return of decedent was filed on September 20, 1988, those facts were still unknown, but that extension of time form, with its explanatory statement, was attached to the return. We think this extension of time (with explanation), which was adhered to by petitioner, was a 'statement attached to the return' and thus falls within the language of section 6501(e)(2). It gave adequate notification to respondent of petitioner's failure to itemize and value specific items of decedent's gross estate that concededly should be returned for estate tax purposes, and the reasons therefor. The estate tax return itself said nothing to the contrary. In fact, as the stipulated facts show, petitioner did not find out the items of the gross estate, and their value, which properly formed part of decedent's gross estate, until September 19, 1991. *Id*.

[D] Redeterminations

The Taxpayer Relief Act of 1997 amends IRC § 6501(c)(9) to provide that any item disclosed on a gift tax return may not be redetermined by the IRS after three years.

[E] Discharge from personal liability

Under IRC § 2204, the personal representative may request a discharge from personal liability, which is done by a separate letter request, usually filed with the return. When the Form 706 is properly filed and the tax paid, the personal representative will be released from liability nine months after the date of filing of the Form 706 or the request for discharge, whichever is later. Document 3, Request for Discharge from Personal Liability, is a sample request that can be adapted to create a request for any estate.

IRC § 2204 also provides for discharge of liability on the furnishing of bond for any amount extended under IRC §s 6161, 6163, or 6166, but in the author's experience, the difficulty of obtaining a bond makes obtaining a discharge when taxes are

extended a practical impossibility. The executor will still remain liable in the executor's fiduciary capacity. IRC § 6901.

Document 4 - Request For Discharge Of Liability

ESTATE OF JOHN Q. SAMPLE
Richard V. Sample, Independent Executor
1313 Ruele
San Antonio, Texas 78299

July 30, 2004

Internal Revenue Service
Cincinnati, Ohio 45999

Re: Estate of John Q. Sample
Social Security No.: 987-65-4321
Date of Death: September 30, 2003

Request for Discharge of Personal Liability

Ladies and Gentlemen:

I am the Independent Executor of the above-referenced estate. I hereby request prompt determination of the Federal Estate Tax owing and a discharge of personal liability for such tax in accordance with Section 2204 of the Internal Revenue Code.

Sincerely yours,

_____
Richard V. Sample, Independent
Executor of the Estate of John Q. Sample

[F] Transferee liability

Under IRC § 6901(c)(1), the period of limitations for assessment of a liability against an initial transferee is one year after the expiration of the period of limitations for assessment against the transferor. Under Treas. Reg. §301.6901-1(a)(3)(i), the donee is liable for the tax and for the interest, but not for any penalties. For an estate where the decedent died December 4, 1981, an assessment within the period of limitations with respect to a transferee was timely filed on December 22, 1997, and the doctrine of laches was held to not apply, See, *Edward Fridovich v. Comm.*, TC Memo 2001-32.

For the transferee to have liability, the U.S. courts must have personal jurisdiction over the transferee, which will depend upon the forum state's long-arm statute. In *M. Subklew*, 2001-2 U.S. TC 60,411 (D.C. Fla.) the transferees contacts, none in the last five years, were not continuous and systematic and were insufficient under Florida's long-arm statute.

[G] Retention of records

All documents and vouchers related to the preparation of the Form 706 should be retained. The executor shall keep complete and detailed records of the affairs of the estate so the IRS can determine accurately the amount of the estate tax liability. Treas. Reg. §20.6001-1(a). No specific retention period is specified in either the law or the regulations, but it seems it should be at least until the six-year statute on omitted items runs.

[H] Assessment

When a tax has been assessed, it may be collected within 10 years of the assessment of the tax. IRC § 6502(a).

§1.18 *Amending returns and claims for refund*

[A] Amended returns

The regulations do not permit amending a Form 706 after the due date, including extensions, but supplemental information can be filed that may result in a finally determined tax different from the amount shown by the executor on the return. Treas. Reg.§20.6081-1(c). Although sometimes called "amended returns" technically they are "supplemental information."

[1] How to file

File another Form 706 and write "Supplemental Information" across the top of page 1. Instructions, p.3. The supplemental information return should be signed by the personal representative and the preparer.

[2] Return under audit

If the return is being audited, the additional information should be provided directly to the office conducting the audit. *Id*.

[3] Consequence of amendment

Amended returns are tolerated as an administrative practice. The IRS is not obligated to change an assessment merely because the taxpayer files supplemental information. *Miskovsky v. U.S.*, 414 F.2d 954, 955-956 (3rd Cir. 1969). Amended returns only have the effect that the IRS chooses to give them. The regulations provide that the supplemental information "may result in a finally determined tax different from the amount shown by the tax on the return." Treas.Reg. §20.6081-1(d) (emphasis added).

[4] Obligation to report omitted assets

What obligations do the preparer and the personal representative have to report assets discovered after the original return has been filed? The regulations may permit the filing of supplemental information but there is no statutory requirement that supplemental information be filed.

[a] Fraudulent returns

In *Badaracco v. Comm.*, 464 U.S. 386, 394 (1984), the court held that an amended return did not

cure fraud on the original return. Filing an amended return on later discovered assets does not cure the fraud on the original return. Further, failure to disclose later discovered assets does not in turn cause the original return to be fraudulent. However, disclosing newly discovered assets may make the original filing look less like fraud. Filing before the IRS discovers the omission may result in fewer penalties and less interest.

[b] Inadvertent omissions

More often the preparer will be faced with newly discovered assets that inadvertently were not disclosed on the original return. If there is no audit, a failure to disclose the assets within the three year period for assessment appears to not be required where the omission on the original return was in good faith. Is there an obligation on the part of the preparer to nevertheless advise the personal representative to disclose the omitted assets? Treas. Circular 230 states:

> **§10.21 Knowledge of client's omission.** Each attorney, certified public accountant, enrolled agent, or enrolled actuary who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client is required by the revenue laws of the United States to execute, shall advise the client promptly of the fact of such noncompliance, error, or omission.

It is possible to read this requirement as only applicable to an omission on an as yet unfiled original return. But, it is also possible to read it as requiring the preparer to advise the personal representative to correct the omission. It would seem that if within the statute of limitations period the preparer needs to advise the executor of possible penalties if the IRS discovers the assets on its own as well as increased interest caused by delay in reporting.

If there is an audit or if a claim for refund has been filed, then to avoid making false or misleading statements to the IRS, the assets must be disclosed.

If the assets are discovered more than six years after the original Form 706 was filed, assessment of tax and penalties will be barred. PLR 8626042.

Does MRPC 3.3 prohibit a lawyer from assisting a client in failing to report a material fact if the failure or omission is fraudulent? Can a failure or omission discovered after first filing the original return in good faith be fraudulent?

[c] Duty to supplement as to debts

See discussion in Chapter 15, "Schedule K, Debts, Mortgages and Liens."

[B] Claims for refund

The proper manner in which to get money back from the IRS is to file Form 843, Claim for Refund and Request for Abatement. Under IRC § 6511(a) a claim for refund of overpayment of the tax must be made within three years of the due date for the return, plus filing extensions or, or two years from the date of payment, whichever is later.

Receipt of a closing letter, even after extensive negotiations and compromises with the field agent or appeals, does not prevent filing a claim for refund. A closing agreement will foreclose filing a claim for refund.

[1] When does refund period start?

In *Zeier v. U.S.*, 80 F.3d 1360, 1363-1364 (9th Cir. 1996), the court held that an estate was not entitled to an estate tax refund because the refund claim was not made within three years of filing of the original estate tax return. Although the original return was based upon estimated values and did not include any schedules, a return "as complete as possible" must be filed before any extension period runs and the return thus filed will be the return required by the IRC, citing Treas.Reg. § 20.6081-1(c). It was a valid return for purposes of IRC § 6511(a) limitations period because it provided a sufficient basis for calculating the estate's tax liability.

[2] Administrative action before court action

A claim for refund, using Form 843, Claim for Refund and Request for Abatement, must be filed with the IRS before bringing an action in U.S. district court. In *Estate of Powell* v. U.S., 86 AFTR 2000-5310 (U.S. Va. 2000), a U.S. district court held that it lacked jurisdiction over an estate's refund suit for estate taxes because the estate failed to file an administrative claim for the refund with the IRS prior to filing suit in court. When an estate tax return was filed in 1996, it included as an asset value an anticipated $136,920 gift tax refund. The estate contended there was no overpayment of estate taxes until its gift tax refund was disallowed in 1999 and that a timely administrative claim for a gift tax refund constituted a timely request for an estate tax refund. Even though computations of the two refund claims are mathematically related, the court found that gift and estate taxes are separate liabilities triggered by different time periods and subject to different statutes of limitations. What could the estate have done differently? It should have timely filed an administrative claim for refund with the IRS on the estate taxes and, because the gift tax refund was uncertain, possibly it should not have been returned at full value or returned with no value.

[C] Summary on disclosing information.

As to newly discovered information, this summarizes the discussion above:

- When the original return has been filed in good faith, after discovered assets need not be reported to the Service as supplemental information. The same is true for deductions subsequently lost, under reported values, over reported deductions, and mathematical errors in the taxpayer's favor.
- After discovered assets, deductions subsequently lost, under reported values, over reported deductions and mathematical errors in the taxpayers favor will in all probability need to be reported in the event of an audit in order to meet the good faith and honesty requirements of Circular 230. They will also need to be reported if otherwise making a claim for refund as indicated below.
- The proper way to report over reporting of assets, under reporting of deductions and mathematical errors in the Service's favor is a claim for refund, which must be filed within the statute of limitations for filing a claim for refund. In making a claim for refund, all newly discovered information must be included, both the information that is favorable to the client and the information that is not favorable to the client. If on balance, the newly discovered information is more favorable to the Service than the taxpayer, in the absence of an audit by the Service, and predicated upon a initial filing in good faith, there need not be information disclosure to the Service initiated by the taxpayer or taxpayer's estate tax return preparer.

§1.19 *Power of attorney*

[A] On Form 706

Page 2 of the Form 706 contains an authorization for one attorney, accountant, or enrolled agent to represent the estate and receive confidential tax information. This authorization does not authorize the representative to enter into closing agreements for the estate.

As of July 8, 2002, the Cincinnati Service Center has a toll free number for inquiries on the status of Form 706 filings, including claims, amended returns and extensions, at 866.699.4083. Preparers who sign Page 2, Part 4, General Information, may call without the need for a Form 2848 or Form 8821, discussed below.

[B] Form 2848

A Form 2848, Power of Attorney and Declaration of Representative, must be completed and submitted in the following instances:

(1) To authorize persons other than attorneys, accountants and enrolled agents (and other than the person required to file and sign the return) to receive confidential information or represent the estate.

(2) To authorize more than one person to receive confidential information or represent the estate.

(3) To authorize a person to enter into closing agreements for the estate.

[C] Form 8821

A Form 8821, Tax Information Authorization, authorizes some one to inspect and/or receive confidential tax information but not to represent the estate before the IRS.

[D] When filed

Representation of the estate becomes important only in the event of an audit, so the filing of a Form 2848 is usually delayed until an audit is commenced, unless there is a reason for more than one person to receive confidential tax information or represent the estate prior to audit or to authorize a person other than an attorney, accountant, enrolled agent, or the person signing the return to receive confidential tax information or represent the estate prior to audit.

§1.20 *Version of return*

The proper revision of the Form 706 must be filed, based on the date of death of the decedent. Table 5, Form 706 Revisions, gives the proper revision to be filed depending upon the date of death.

References to instructions on the form, in this article, will be indicated as "Form, p.x," and references to the separate brochure will be indicated as "Instructions, p.x."

[A] Forms on internet

The address to access IRS forms on the Internet is:

http://www.irs.ustreas.gov/prod/forms_pubs/

When the page appears, click on Forms & Instructions. It is self-explanatory. You will need Adobe Acrobat to download and/or print the forms.

Table 5
Form 706 Revisions

For Decedents Dying After	And Before	Use Revision of Form Dated
Dec. 31, 1981	Oct. 23, 1986	Nov. 1987
Dec. 31, 1989	Oct. 9, 1990	Oct. 1988
Oct. 8, 1990	Jan. 1, 1998	Apr. 1997
Dec. 31, 1997	Jan. 1, 1999	July 1998
Dec. 31, 1998	Jan. 1, 2001	July 1999
Dec. 31, 2000	Jan. 1, 2002	Nov. 2001
Dec. 31, 2001	Jan. 1, 2003	Aug. 2002
Dec. 31, 2002	Jan. 1, 2004	Aug. 2003
Dec. 31, 2004	Jan. 1, 2005	Aug. 2004

[B] Estate tax return preparation software

Attached as Appendix D is a brief article regarding Form 706 preparation software.

[C] Several other forms carry the number 706.

Form	Table 6 Forms 706 Name
706A	United States Additional Estate Tax Return *(To report dispositions or cessations of qualified use under Section 2032A of the Internal Revenue Code)*
706	United States Estate (and Generation-Skipping Transfer) Tax Return *(Estate of a citizen or resident of the United States)*
706-CE	Certificate of Payment of Foreign Death Tax
706-D	United States Additional Estate Tax Return Under Code Section 2057
706-GS(D)	Generation-Skipping Transfer Tax Return for Distributions
706-GS(D-1)	Notification of Distribution From a Generation-Skipping Trust
706-GS(T)	Generation-Skipping Transfer Tax Return for Terminations
706-NA	United States Estate (and Generation-Skipping Transfer) Tax Return *(Estate of non-resident, not a citizen of the United States)*
706-QDT	United States Tax Return for Qualified Domestic Trusts

§1.21 *Audit*

[A] Historical probability of audit

It has been reported that the Form 706 audit rate is 20%, approximately ten times the audit rate of the income tax return. Yet, the audit rate exceeds 50% when the gross estate exceeds one million dollars. Estates, Gifts and Trusts, TAX MANAGEMENT PORTFOLIO, 463 I.A.9.

[B] Current probability of audit

Because the criteria under which returns are selected for audit and the amount of resources the Internal Revenue Service can dedicate to audits are subject to change, historical rates of audit and past selection criteria may provide little or no indication of the chances a return will be audited.

> FEWER SMALL ESTATES face a grilling from IRS auditors. An IRS publication shows 102,300 estate tax returns were filed in 1997. Auditors examined about 10.2% of the total. That was down sharply from 16.9% five years earlier and 22.8% a decade earlier. Officials cite "budget constraints" as the main reason for the drop. But the larger the estate, the greater the chances of attracting IRS attention.
>
> The IRS in 1998 audited only 5% of estates valued at less than $1 million, nearly 15% of those valued at between $1 million and $5 million, and about 40% of those valued at $5 million or more. "The IRS is focusing its efforts on taxable estates of size," says Joshua S. Rubenstein, chairman of the Rosenman & Colin law firm in New York. For the biggest taxable estates, "there's probably no difference in the frequency of audits."
>
> *Wall Street Journal*, December 13, 2000

The article "Using a Sample of Federal Estate Tax Returns to Examine the Effects of Audit Revaluation on Pre-audit Estimates" by Martha Britton Eller and Barry W. Johnson, both with the IRS, has some interesting information regarding estate tax return audit triggers. The full article is available on the web at:

http://ftp.fedworld.gov/pub/irs-soi/estaudit.pdf

The authors describe the process of determining whether or not a return will be audited as "highly subjective," yet they net with auditors in several regions and developed criteria used in selecting audit cases.

In addition to the fact that the estate tax returns of non-married decedents are much more likely to be audited (because returns of married decedents usually use the marital deduction to avoid tax), the authors identify the following factors as important in the audit selection process:

1. fees (including executor's commissions and attorneys' fees) >5% of total gross estate,
2. adjusted taxable gifts >5% of total gross estate,
3. other non-corporate business assets >5% of total gross estate,
4. other stock >30% of total gross estate,
5. credit for tax on prior transfers >0,
6. art >0,
7. decedent has a power of appointment over trust property,
8. closely-held stock >5% of total gross estate,
9. real estate >50% of total gross estate,
10. lifetime transfers >30% of total gross estate, and
11. total gross estate >$5,000,000.

There are non-quantifiable factors that may affect audit probability. While decreasing the chances of an audit, they do not present negative consequences that make it questionable if they should be followed.

Neatness and accuracy are factors that may decrease audit chances.

> A return that does not follow all of the instructions carefully, omits data, has arithmetical errors, and to which not all required

documents are attached, is not only more audit prone but will give a poor first impression of the preparer's work to the Estate Tax Attorney examining it. F. Berall, *Preparing the 706*, 22 (National Law Foundation, 1998).

The reputation of the preparer for accuracy and correctness, based on past returns, may decrease audit chances. Failure to answer required questions or attach required documents may increase audit selection. Submitting a full appraisal report rather than a skeletal report may decrease audit chances because questions the IRS may ask on audit are already answered. Contrary to what many clients may think, requesting an extension to file does not appear to affect the chances of audit.

[C] IRS audit policy

The IRS audit policy is to complete audit action within 18 months of filing the return. *IRS Examination Technique Handbook for Estate Tax Examiners*, I.R.M. MT 4350-31 (December 16, 1987) (hereinafter "Examiner's Handbook"), Section 220(3).

[D] Audit process

There are three levels to the audit process: review, survey and examination.

In review, the first level, the return is checked for math errors and completeness. Returns that appear complete and properly prepared will not go on to the next level and the closing letter is sent.

In a survey, the examining attorney determines whether to devote substantial time to audit. The examining attorney reviews public records, attachments to the return and personal experience, without contacting the preparer to determine if an audit is necessary. The review stops at the survey level unless the return contains "at least one issue identified likely to result in a material change in tax liability." Examiner's Handbook, Section 312(4).

Examination is entered when the return discloses at least one issue identified likely to result in a material change in tax liability. The examining attorney will contact the preparer, usually in a letter, specifying documents to be produced and examination issues.

Treas. Circular 230 provides guidance on furnishing information that appears to be applicable to preparers during audit:

> **§10.20 Information to be furnished.** (a) *To the Internal Revenue Service*. No attorney, certified public accountant, enrolled agent, or enrolled actuary shall neglect or refuse promptly to submit records or information in any matter before the Internal Revenue Service, upon proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, or shall interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service or its officers or employees to obtain any such record or information, unless he believes in good faith and on reasonable grounds that such record or information is privileged or that the request for, or effort to obtain, such record or information is of doubtful legality.

Further, the preparer must be prompt according to Treas. Circular 230:

> **§10.23 Prompt disposition of pending matters.** No attorney, certified public accountant, enrolled agent, or enrolled actuary shall unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

[E] General overview

For an excellent description of the audit process for a preparer who has not been through an audit before, *See*, Newlin & Glenn, *The Estate Tax Audit: How to Prepare and Succeed*, ESTATE PLANNING, Jan.-Feb., 1992 at 37.

§1.22 *Number of copies*

Number of copies Only one copy of the estate tax return needs to be filed with the IRS. Rev. Rul. 56-471, 1956-2CB 935. A copy will typically be filed with the state return. Table 7, Form 706 Copies, has a list of possible recipients of a copy of the Form 706 as well as most state returns.

Table 7
Form 706 Copies

#	IRS Original
	State Returns, each
	Executor(s), each
	Attorney
	Accountant
	Beneficiaries, each
	Trustees of Testamentary Trust, Each
	Total Copies to be made

§1.23 *Confidentiality*

[A] Beneficiary access

Under the common law duty of disclosure, the executor may have a fiduciary duty to provide a copy of the completed and filed Form 706 to a beneficiary who requests it.

[B] Public access

The general public cannot access a copy of the Form 706 nor the IRS audit or investigative file under a Freedom of Information Act request. The IRS is not required to disclose documents exempted from disclosure by a withholding statute. 5 U.S.C §552 (b)(3) (West 2001). The IRC provides that tax returns and return information are confidential and may not be disclosed except as authorized by the IRC. IRC § 6103(a). Estate tax returns and related

information may be disclosed to the administrator, executor, or trustee of the estate. IRC § 6103(e)(1)(E)(i).

§1.24 *Circular 230 covered opinions*

Regulations under Treasury Circular 230 were issued on December 20, 2004, and become effective, unless modified, on June 20, 2005. A number of new provisions, contained in §10.33, are labeled "best" practices" which are aspirational in nature, not mandatory in that failure to comply will not result in discipline under the Circular, but failure to adhere to a suggested best practice could be used against a practitioner in a lawsuit or a disciplinary proceeding. Some of the best practices are clear communications with clients, establishment of relevant facts by the practitioner, and informing clients of the full import of conclusions reached by the practitioner. These are not limited to tax shelters because Circular 230 applies to any tax.

Minimum required practice rules with respect to a written discussion of a federal tax matter are contained in Circular §10.35. Written discussions will apply to everything in writing, including emails and faxes. The writings to which this section applies are "covered opinions" and are not limited to what practitioners regard as "formal written legal opinions."

A covered opinion is "written advice" by a practitioner concerning one or more federal tax issues (including any estate, gift, or GST tax issues) arising in six categories. A writing may fall into more than one category of covered opinions. It may be that mere recitals of the provisions of the IRC (e.g., "IRC § 2056 provides for a marital deduction") may constitute advice that may be tested to determine if it is a covered opinion.

1. Listed Transactions. Written advice arising from a transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the IRS has determined to be a tax avoidance transaction and identified by published guidance as a "Listed Transaction" under Treas. Reg. §1.6011-4(b)(2). No traditional estate planning arrangement is a Listed Transaction and so this generally will not be applicable to the preparation of a Form 706.

2. Tax Avoidance as Principal Purpose as Arrangement. Written advice arising from any partnership or other entity, any investment plan or arrangement, or *any other plan or arrangement* the principal purpose of which is the avoidance or evasion of *any tax* imposed by the IRC. Some would view preparing the Form 706 as being infused with the avoidance of tax.

3. Reliance Opinions. If tax avoidance is not the principal purpose of the arrangement but is a *significant purpose*, any written advice regarding it is a covered opinion subject to Circular 230 if the written advice concludes at a confidence level of "more likely than not" (greater than 50 percent likelihood) that one or more *significant* federal tax issues would be resolved in the taxpayer's favor. A tax issue is significant if the Service has a reasonable basis for a successful challenge and its resolution could have a significant effect whether beneficial or adverse under any reasonably foreseeable circumstance, on the overall federal tax treatment of the transaction or matter. The Service need not win the issue, it only needs a reasonable basis for a successful challenge, yet no guidance is provided as to how a practitioner makes that determination.

An exception permits the practitioner to fall outside of the Reliance Opinion category when the "practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer." Prominently disclosed, means bolded typeface that is larger than any other typeface used in the written advice.

Preparation of the Form 706 and making the elections thereon, such as the QTIP election, may within the purview of Circular 230, have as a significant purpose the avoidance of tax. Is it tax avoidance or tax deferral? We do not know.

4. Marketed Opinions. This is written advice that relates to an arrangement a significant purpose of which is tax avoidance or evasion and if the practitioner knows or has reason to know that it will be used or referred to by a person other than the practitioner (or someone affiliated with his or her firm) in promoting, marketing or recommending an arrangement to one or more taxpayers. This will have little or no applicability to preparation of the Form 706.

5. Conditions of Confidentiality. Written advice with respect to a federal tax issue involving an arrangement a significant purpose of which is tax avoidance or evasion that is subject to conditions of confidentiality is a covered opinion.

6. Contractual Protection. Written advice with respect to an arrangement, a significant purpose of which is tax avoidance or evasion, subject to contractual protection is a covered opinion. Contractual protection means the taxpayer has the right to a full or partial refund of fees paid to the practitioner if all or part of the intended tax consequences from the matters addressed are not sustained, or if the fees are contingent on the taxpayer's realization of tax benefits from the transaction.

"Covered opinion" rules require the adviser to ascertain and establish all relevant facts. Unreasonable assumptions cannot be used, nor can unreasonable factual representations made by the client or others be relied upon by the adviser, such as the existence of a valid business purpose unless the representation specifically describes the business purpose. The opinion cannot take into account the chances of audit, or the likelihood of success or settlement if an audit occurs. Reasonable efforts will be an objective test rather than an subjective test and the facts upon which the practitioner relies must be in a separate section of the written notice. The practitioner must not base the opinion on any unreasonable factual assumption, which is one that the practitioner knows or should know is incorrect or incomplete. The Circular illustrates that it is unreasonable to assume that a transaction has a business purpose or is potentially profitable apart from tax benefits.

The practitioner must relate the applicable law to the facts, and applicable law includes potentially applicable judicial doctrines, unspecified in the Circular. Judicial doctrines are not codified and are uncertain in scope and content, and vary by judicial circuit. They may include, among others, the substance over form doctrine, the business purpose doctrine, the economic substance doctrine, the step transaction doctrine, the reciprocal trust and reciprocal transfer doctrines. A doctrine that does not apply probably should be mentioned along with an explanation as to why it does not apply. Inconsistent legal analyses or conclusions must not be included.

The opinion must address all significant federal tax issues (except as provided below with respect to limited scope opinions) or with respect to opinions that rely on the opinion of another practitioner. With respect to each significant federal tax issue, the opinion must provide a conclusion as to the likelihood that the taxpayer will prevail on the merits on each such issue considered in the opinion and describe the reasons for the conclusions including the facts and analysis. If the practitioner is unable to reach a conclusion as to an issue, the opinion must so state and describe the reasons the practitioner is unable to reach a conclusion as an issue.

When the practitioner cannot reach a more-likely-than-not level of confidence with respect to one or more significant federal tax issues considered, the opinion must disclose that and must prominently disclose the legend "the opinion was not written and cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer."

The opinion must state the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the arrangement is the proper treatment and the reasons for that conclusion.

The practitioner must be knowledgeable in all aspects of federal tax law relevant to the opinion rendered. The practitioner may rely on another's opinion with respect to one or more significant federal tax issues, unless the practitioner knows or should know that the opinion of the other should not be relied upon. The other opinion relied upon must be identified and its conclusions set forth.

A limited scope opinion may be issued that considers less than all of the significant federal tax issues if (i) the practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for avoiding penalties that may be imposed are limited to the federal tax issues that are addressed in the writing, (ii) the opinion does not involve the listed transaction or an arrangement the principal purpose of which is tax avoidance and is not a marked opinion, and (iii) the opinion includes certain required disclosures. The problem with limited scope opinions in the preparation of the Form 706 is that any written advice would have the principal purpose to avoid tax.

Firms will need to have compliance officers to ensure adherence to the new rules. Failure to comply may result in disbarment or suspension of practice before the IRS, or censure, or fines.

So, how exactly does Circular 230 apply to the preparation of the Form 706? We don not know. Stay tuned.

§1.25 *Confidentiality notices*

[A] Gramm-Leach-Bliley Act

Financial institutions must provide notices that describe each company's privacy policies and practices as required by the Gramm-Leach-Bliley Act, Pub. Law 106-102 November 12, 1999 ("GLB") and the correlative FTC regulation, 16 CFR Part 313 (May 24, 2000). The act's purposes are:

References to instructions on the form, in this article, will be indicated as "Form, p.x," and references to the separate brochure will be indicated as "Instructions, p.x."

(1) to protect against any anticipated threats or hazards to the security or integrity of such records; and

(2) to protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer. GLB Section 6801(b).

The FTC has taken the position that lawyers, law firms, accountants, and accounting firms (hereinafter

"tax firms") that undertake certain types of representation are also required to comply with the notice provisions of the regulation.

[B] Current non-enforcement

The American Bar Association filed suit against the Federal Trade Commission in U.S. District Court for the District of Columbia because of the FTC's effort to regulate client confidentiality and the attorney-client relationship through GLB. Initially, the FTC agreed to a temporary injunction on enforcement pending resolution. The ABA's suit requested the court to declare the FTC interpretation unlawful because it conflicts with the ethical codes by which attorneys in all 50 states and the territories are governed and because GLB was written for financial institutions and not attorneys engaged in the practice of law. On April 30, 2004, Judge Reggie Walton issued an order that the FTC's decision to subject attorneys, providing legal services in real estate settlement, tax planning and tax preparation, to the Act was beyond its statutory authority and constituted arbitrary and capricious agency action. *American Bar Association v. FTC* , CA No. 02-1883.

By letter dated May 7, 2004, Willaim E. Kovacic, General Counsel for the Federal Trade Commission, issued this letter to counsel for the American Bar Association.

> This letter represents that, unless and until the district court's April 30, 2004 order or any judgment embodying that order is reversed, the Federal Trade Commission (FTC) will not bring any enforcement actions or conduct any investigations against practicing lawyers under Title V, Subtitle A, of the Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801-09, for any action, inaction, or failure to comply by them during the period preceding reversal.

[C] Representations subject to notice

The regulation applies to financial institutions, which is defined as a business that is engaged in financial activities described in §4(k) of the Bank Holding Company Act of 1956, 12 USC §1843(k); 66 CFR 313(k). Of the listed activities those applicable to tax firms include "providing tax planning and tax preparation services to any person." 12 CFR 225.28(b)(6)(vi). The regulations provide that return preparation or tax advice are within the scope of the notice provision if they are rendered to an individual (or the individual's personal representative) and are used primarily for personal, family or household purposes. Section 313(e) and 313(h). Thus, if a tax firm renders personal tax advice (income, gift or estate) or prepares personal tax returns (income or gift), it is engaging in financial activities subject to the notice requirements.

[1] Excluded activities

The comments to the FTC rule make it clear that personal does not include any tax advice given for business purposes, whether as a sole-proprietor, partner, as shareholder, and these rules do not apply to plan sponsors, trusts, estates or any other fiduciary relationship. If preparation of the Form 706 is strictly limited to assisting the personal representative, whether an individual or a corporation, in preparing the Form 706, the notice requirements will not apply. But, can the tax firm completely limit itself to preparing the Form 706 and not give personal tax advice to beneficiaries, particularly where the spouse or other beneficiary serves as the personal representative? It may be possible to limit the engagement where a corporate fiduciary is the personal representative and the engagement explicitly excludes advice to the beneficiaries. With individual personal representatives, the preparation of the estate tax return itself will not require the notice, but the individual tax advice, such as on disclaimers, QTIP election, special valuation of farm or business, among others, will.

[2] Excluded tax firms

The regulation does provide that an entity that is engaged in financial activities but is not "significantly engaged in those financial activities" is not a financial institution. There is little guidance on how to interpret "significant," but this author has learned that in informal advice the FTC has advised that if an entity holds itself out as undertaking the listed financial activities such activities are "significant," without regard to dollar volume, and without regard to the percentage of the revenue of the overall firm that they represent. Thus, it appears to be impossible for an attorney or accountant that holds oneself out as preparing an estate tax return, which is inherent in the engagement, to be excluded.

[D] Notice requirements

[1] Pre-July 1, 2001 notice

By July 1, 2001, notice of the tax firm's privacy policy and practices must be sent to any individual with whom the tax firm has a customer relationship. A customer is one for whom the tax firm has provided the covered financial services for personal use, and who has not become a former customer. Because this notice may have been missed, a make-up notice may be required, but no guidance is given on making-up a missed notice.

[2] Former customer

For tax preparation a customer is a "former" customer if the tax firm has provided and received payment for the service and no longer provides any statements or notices to the customer concerning that relationship. §313.5(v)(2) ex (v). Overall, a customer is a "former" customer if the tax firm has not communicated with the individual for a period of 12 consecutive months, other than to provide annual privacy notices or promotional materials.

[3] Engagement notice

After July 1, 2001 when a new client engages a tax firm to undertake a listed financial activity, the firm must provide notice of its privacy policy and practices to the individual. The best place to give this notice may be the engagement letter.

[4] Annual notice

On an annual basis, starting in 2002, a tax firm is to provide a notice of its privacy policy to clients for whom it performs the listed financial services, unless the client is a "former" customer, as defined above. Tax firms will need a system to identify clients included within the notice requirement with which it has a continuing relationship.

[E] Notice contents

The regulations provide great detail on what needs to be in a notice.

(i) The categories of nonpublic personal information that the financial institution collects;

(ii) The categories of nonpublic personal information that the financial institution discloses;

(iii) The categories of affiliates and non-affiliated third parties to whom the financial institution discloses nonpublic personal information, other than those parties to whom it discloses information under §§ 313.14 and 313.15;

(iv) The categories of nonpublic personal information about the financial institution's former customers that it discloses and the categories of affiliates and non-affiliated third parties to whom the financial institution discloses nonpublic personal information about its former customers, other than those parties to whom it discloses information under §§ 313.14 and 313.15;

(v) If the financial institution discloses nonpublic personal information to a non-affiliated third party under §313.13 (exceptions to the opt out notice)(and no exception under §§ 313.14 and 313.15 applies to that disclosure), a separate statement of the categories of information it discloses and the categories of third parties with whom it has contracted;

(vi) (vi) an explanation of the consumer's right under §313.10(a) to opt out of the disclosure of nonpublic personal information to non-affiliated third parties, including the methods by which the consumer may exercise that right at that time;

(vii) Any disclosure that the financial institution makes under section 603(d)(2)(iii) of the Fair Credit Reporting Act (15 U.S.C. 1681a(d)(2)(A)(iii) (that is, notices regarding the ability to opt out of disclosures of information among affiliates);

(viii) the financial institution's policies and practices with respect to protecting the confidentiality and security of nonpublic personal information; and disclosure authorized under §§ 313.14 and 313.15).

(ix) Any disclosure that the financial institutions makes under paragraph (b) of this section (relating to disclosure authorized under §§ 313.14 and 313.15).

Because a law firm is precluded from disclosing non-public information by the Rules of Conduct, there is not much to be disclosed. An accounting firm has similar limitations, with not much to be disclosed, because of Rules of Professional Conduct and the Internal Revenue Code. In informal conversations with FTC, staffers have indicated that a brief statement by the firms would be sufficient. Below is a privacy notice provided by the Tax Section and Probate Section of the Philadelphia Bar Association.

Privacy Policy Notice Attorneys, like other professionals who advise on personal financial matters, are now required by the Gramm-Leach-Bliley Act to inform their clients of their policies regarding privacy of client information. Attorneys have been and continue to be bound by profession standards of confidentiality that are even more stringent than those required by this new law. Therefore we have always protected your right to privacy. In the course of providing our clients with income tax, estate tax, and gift tax advice, we receive significant personal financial information from our clients, If you are a client of [law firm name], you should know that all information that we receive from you is held in confidence, and is not released to people outside the firm, except as agreed to by you, or as required under an applicable law. We retain records relating to professional services that we provide so that we are better able to assist you with your professional needs and, in some cases, to comply with professional guidelines. In order to guard your nonpublic personal information, we maintain physical, electronic, and procedural safeguards what comply with our professional standards.

[F] Sanctions

What are the sanctions for failure to comply with the notice rules?

[1] Non disclosure

Under the GLB, one penalty is that the financial institution will be precluded from divulging any private information. Since a law firm or an accounting firm is already precluded from such actions, that sanction would have no meaning.

[2] Fines

The general FTC Act would empower the FTC to require compliance although there may be issues with respect to the agency's regulating attorney or certified public accountant activities. The FTC has the power to impose a $10,000 fine per failure to comply, although in practice that seems to be rarely applied.

2 VALUATION

§2.01 *Significance of valuation*

IRC § 2031(a) states that the *value* of the gross estate includes "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situate." The need to value assets differentiates preparation of estate tax returns from preparation of income tax returns. Most income tax issues involve cash transactions and the valuation issues with non-cash assets occur infrequently in income tax return preparation. Some of these infrequent valuation issues that arise with income tax returns are:

(i) Valuation of non-cash assets contributed to charitable organizations;

(ii) Valuation of assets lost due to casualty;

(iii) Valuation of assets distributed out of a corporation upon a taxable liquidation; and

(iv) Allocation of cost of assets in a bulk purchase between depreciable and nondepreciable assets.

In estate tax return preparation, cash transactions are present, but valuation issues occur frequently. The preparer more familiar with preparing income tax returns should be wary of any tendency to rush to write down a number, simply because the preparer has a number. That number must first be analyzed for appropriateness.

§2.02 *Value defined*

Treas. Reg. §20.2031-1(b) sets forth the definition of fair market value for estate tax purposes.

> The fair market value is the price at which the property would change hands between a willing buyer and 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 includable 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. Thus, in the case of an item of property includable in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail...All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

The same definition is set forth in Treas. Reg. §1.170A-1(c)(2) for charitable contributions for income tax purposes and in Treas. Reg. §25.2512-1 for gift tax purposes. In *Anselmo v. Comm.*, 757 F.2d 1208, 1214 (11th Cir. 1985), the court held that there should be no distinction between the measure of fair market value for estate and gift tax purposes and charitable contributions under the income tax law.

[A] Hypothetical buyer and seller

The willing buyer and willing seller are hypothetical persons, making it generally irrelevant who the actual seller or buyer is. *U.S. v. Simmons*, 346 F.2d 213, 217 (5th Cir. 1965); *Bright's Estate v. U.S.*, 658 F.2d 999, 1001 (5th Cir. 1981).

> "The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer." *Pabst Brewing Company v. Comm.*, TC Memo., 1996-506.

While under the willing buyer and willing seller test the preparer considers hypothetical persons engaged in a hypothetical transaction, that hypothetical transaction does not occur in a vacuum. When considering particular facts and real world scenarios, avoid particularizing the hypothetical persons and making them actual persons. This error

> Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true.
>
> Justice O. W. Holmes
> *Ithaca Trust Co. v. U.S.*, 279 U.S.149

can occur by the taxpayer's appraiser, the IRS appraiser, even the Tax Court. In *Morrissey v. Comm.*, No. 99-71013 (9th Cir. 2001) the Ninth circuit found that the Tax Court erred when it speculated regarding the identity of the willing buyer.

> The Tax Court . . . engaged in the speculation that the Estate stock could be sold to a non-family member and that, to avoid the disruption of family harmony, the family members, or . . . [the company] itself would buy out this particular purchaser. The law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular.

There is no requirement that the hypothetical buyer or hypothetical seller be reasonable. Once the appraiser establishes a properly supported value the reasonableness of the hypothetical seller or buyer does not modify the value.

The distinction between actual and hypothetical buyers and sellers can become decisive in the outcome. Consider this language by the Fifth Circuit affirming *Louis R. Smith v. United States*, 300 F. Supp. 2d 474 (D.C.Tex. 2004), __ F.3d ___ (2004).

> In its brief, the Estate argues that the fair market value of the Retirement Accounts should reflect its "inherent income tax liability." Specifically, it asserts that the value of the assets in the Retirement Accounts should have been discounted to reflect the federal income tax liability to the beneficiaries upon distribution from the accounts. The Estate fails to acknowledge that the willing buyer - willing seller test is an objective one. For us, the hypothetical parties are not the Estate and the beneficiaries of the Retirement Accounts. Accordingly, we do not consider that the particular beneficiaries in this case are receiving income in respect of the decedent and will eventually pay tax on the distributions from the Retirement Accounts because doing so would alter the test from a hypothetical sale into an actual one. Applying the test appropriately then entails looking at what a hypothetical buyer would pay for the assets in the Retirement Accounts. The Retirement Accounts consist of stocks and bonds. A hypothetical buyer would pay the value of the securities as reflected by the applicable securities exchange prices. A hypothetical seller would likewise sell the securities for that amount. Correctly applying the willing buyer - willing seller test demonstrates a hypothetical buyer would not consider the income tax liability to a beneficiary on the income in respect of the decedent since he is not the beneficiary and thus would not be paying the income tax.
>
> ***
>
> ... [T]he Retirement Accounts at issue here would not constitute income in respect of the decedent in the hands of a hypothetical buyer. Income in respect of the decedent can only be recognized by: (1) the estate; (2) person who acquires the right to receive the income by reason of the decedent's death; or (3) the person who acquires the right to receive the income by bequest, devise, or inheritance. 26 USC §691(a)(1). Thus, a hypothetical buyer would not buy income in respect of the decedent, and there would be no income tax imposed on a hypothetical buyer upon the liquidation of the accounts.

[B] Reasonable knowledge

Reasonable knowledge of relevant facts is not limited to what is actually known on the valuation date. It includes facts discoverable through reasonable investigation if such facts existed as of the valuation date, even if not actually known then. *Estate of Isaac W. Baldwin v. Comm.*, 18 TCM (CCH) 902 (1959). Subsequent events actually occurring after the valuation date may not be considered unless reasonably foreseeable as of the valuation date. *Morris v. Comm.*, 761 F.2d 1195, 1200-1201 (6th Cir. 1985). The definition does not require knowledge of all relevant facts.

[C] Question of fact or law

Valuation is generally a question of fact with case law providing little precedential value. *Messing v. Comm.*, 48 TC 502 (1967). The criterion that should be used in determining value is a question of law. *L.B. Maytag v. Comm.*, 187 F.2d 962, 966-967 (10th Cir. 1951). Because valuation is not a question of law, valuation discounts approved in reported cases have no precedential value.

[D] Appraiser-client privilege

According to the leading case of *Estate of Halas v. Comm.*, 94 TC 570 (1990) there is no "appraiser-client privilege." The IRS may use the services of an appraiser previously used by the decedent or the estate. By contract you may want to foreclose the IRS from hiring the appraiser in the future with regard to the assets appraised. See "Appraiser Engagement Letter Checklist" in Chapter 6.

[E] Appraisal process

Consider requesting that no appraisal report be prepared until the appraiser first reports to the preparer the value. See "Appraiser Engagement Letter Checklist" in Chapter 6. If the oral value substantially varies from the expected value, pay for the appraisal work performed to date and request that no further work be performed and no report be prepared. No report needs to be produced to the IRS upon its request during audit for all written reports.

§2.03 *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.

[A] No de facto forced sale

Estate of Georgia T. O'Keefe v. Comm., 63 TCM (CCH) 2699, involved a blockage discount for 400 works of her art. The tax court rejected the estate's argument that fair market value implies that the property must change hands on the date of death was in effect a forced sale. "That argument is unsupported by authority or reason and ignores the concepts of willing buyers and willing sellers acting without compulsion – the defining factors in a fair market value transaction." To your author, it seems that a block of items that need to be disposed of over a period of time should receive a substantial discount for the time value of money and the risk involved with changing markets over time.

[B] The moment of death

While we may speak of valuation on the "valuation date," value may actually be at the *moment of death* where there is one value while the decedent is alive and an entirely different value for the same asset when the decedent is deceased, all in the same day. "Brief as is the instant of death, the court must pinpoint its valuation at this instant - - the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins." *U.S. v. Land*, 303 F.2d. 170, 172 (5th Cir. 1962).

In *Estate of McClatchey v. Comm.*, 147 F.3d 1089, 1091 (9th Cir. 1998), a case that your author describes as a "metaphysical case" dealing with the metaphysics of death, is an important case on timing for estates where death affects the value of estate assets. The appeals court held that 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. The court fails to address, at the infinitesimally small point in time that death occurs, whether the restrictions existed or did not exist, which logically are the only two choices.

> There is no question that the estate tax is on the transfer of property at death and that, therefore, the property to be valued is the interest transferred at death, "rather than the interest held by the decedent before death or that held by the legatee after death." *Propstra v. United States*, 680 F.2d 1248, 1250 (9th Cir. 1982) (citing *Estate of Bright v. United States*, 658 F.2d 999, 1001 (5th Cir. 1981) (en banc)), 147 F.3d at 1091.

The court found that unregistered securities restricted under Rule 144 of the Securities Act of 1933 should be valued at their lower restricted price, noting that 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 restriction. The court reasoned that, had the estate been an affiliate, then the restrictions on sale of the stock would have continued to apply. In effect, the value without the restrictions was held to be the value at the moment of death.

McClatchey was decided in the same circuit as *Ahmanson Foundation v. US*, 674 F.2d 761 (9th Cir. 1981), which in dicta offered the following insights into the moment of death.

> [V]alue is to be determined at the moment of death....[W]e must take into account any transformations of the property that are logically prior to its distribution to the beneficiaries.... It is undisputed that the valuation must take into account changes brought about by the death of the testator. Ordinarily death itself does not alter the value of property owned by the decedent. However, in a few instances such as when a small business loses the services of a valuable partner, death does change the value of property....The valuation should also take into account transformations brought about by those aspects of the estate plan which go into effect logically prior to the distribution of property in the gross estate to the beneficiaries. Thus, for example, if a public figure ordered his executor to shred and burn his papers, and then to turn the ashes over to a newspaper, the value to be counted would be the value of the ashes, rather than the papers. Similarly, if a will provides that prior to the distribution of the estate a close corporation owned by the testator is to be recapitalized, with one class of stock in the gross estate exchanged for another, the value of the gross estate would be based on the shares resulting from the recapitalization. ... There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one. *Id.* at 767-68.

In *Ahmanson*, the court rejected the estate's argument that a block of stock should be valued as two blocks of stock because it would be received by two different beneficiaries. Your author questions whether the statements in the case regarding intentionally burned assets and recapitalization are still good law.

See discussion of "Lawsuits" in Chapter 10 on Schedule F.

§2.04 *Alternate valuation*

Alternate valuation permits valuation on a date other than the date of death (sometimes called "DOD"). This other date is called the alternate valuation date (sometimes called "AVD"), which is usually the six month date after decedent's death, and it permits payment of less estate taxes when the overall property has decreased in value subsequent to the date of death.

[A] 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 § 2032(c). If there is no federal tax because of the state death tax credit, then alternate value cannot be used.

[B] How elected

Alternate valuation is elected by checking the appropriate box. Once made the alternate valuation is irrevocable, except it may be revoked on a subsequent return filed on or before the due date of the return, including extensions of time to file actually granted. Prop. Treas. Reg. §20.2032-1(b)(1). While the alternate valuation is irrevocable, the converse is not true: The DOD valuation is not irrevocable.

[1] Late election

The IRS has issued final regulations that amend Treas. Reg. §20.2032-1(2) to reflect changes made to IRC § 2032 by the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986. A relief may be granted under the provisions of Treas. Reg. §301.9100-1 and Treas. Reg. §301.9100-3 for extension of time to make the alternate valuation election provided that the return of tax if filed no later than one year after the due date of the return (including extensions of time actually granted).

[2] Protective election

Prop. Treas. Reg. §20.2032-1(b)(2) provides for making a protective election:

> If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax liability of the estate, a protective election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur. A protective election made on the return of tax imposed by section 2001 is irrevocable, provided that it may be revoked on a subsequent return filed on or before the due date of the return (including extensions of time to file actually granted). Absent such revocation, if it is later determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum (reduced by allowable credits) of the estate tax and generation-skipping transfer tax liability of the estate, the protective election becomes effective and cannot thereafter be revoked.

[C] 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. Treas. Reg. §20.2031-1.

[D] Applicable valuation dates

The property under alternate valuation is valued on the 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. 4.

Examples of property affected by the mere lapse of time include patents, leaseholds, estates for the life of another, and remainder interests.

The regulations set forth the meaning of "distributed, sold, exchanged, or otherwise disposed of." Treas. Reg. §20.2032-1(d). It comprehends all possible ways in which property ceases to form a part of the gross estate. Property is considered "distributed" by an executor or trustee (of property included in the gross estate under IRC §s 2035 through 2038 or 2041) upon the first to occur of the following:

> (i) The entry of an order or decree of distribution, if the order or decree subsequently becomes final;
>
> (ii) The segregation or separation of the property from the estate or trust so that it becomes unqualifiedly subject to the demand or disposition of the distributee; or
>
> (iii) The actual paying over as delivery of the property to the distributee.
>
> Treas. Reg. §20.2032-1(c)(2).

Presumably, a different rule applies to an heir or devisee to whom title to property passes directly under local law.

When there is no day in the sixth month following the decedent's death that corresponds numerically to the date of death, the correct alternate valuation date is the last day of the sixth month. Rev. Rul. 74-260, 1974-1 CB 275.

The alternate valuation date is not fixed by the passing of property to a devisee in a state whose law provides that possession and title to real property passes to the devisee immediately on the decedent's death, but the property remains subject to claims against the estate until a final court order. Rev. Rul. 78-378, 1978-2 CB 229, revoking Rev. Rul. 71-5, 1971-1 CB 270. Under the facts present in the revenue ruling, title to real and personal property passed immediately to the heirs, devisees and legatees, subject to the right of the executor to use the property to satisfy claims and expenses, or to provide for an election by a surviving spouse. The executor was required to take possession of all personal property, but had no right of possession of real property unless the real property must be used to satisfy claims or unless it is necessary for the executor to preserve the property for the devisees, and if expressly authorized by the probate court. The executor never had possession of the real property and the probate court ordered distribution of all real and personal property from the decedent's estate after the six months alternate valuation date. The ruling went on to state that only if an order or decree was not required to establish the legal rights to the delivered property would the property be considered "distributed" upon separation, segregation or actual delivery, and a delivery to a distributee subject to a subsequent court decree is not delivery within the regulations. The revoked ruling, Rev. Rul. 71-5 had concluded that when the executor, who was sole beneficiary, transferred corporate stocks held by the estate to himself in his individual name before a court decree, a distribution was effected. In Rev. Rul. 78-378 the Service said it would no longer maintain the position it took in *Estate of Prell. v. Comm.*, 48 TC 67 (1967) in which the Tax Court sustained the Service in holding that absent a showing of any claims, or the likelihood of any claims against the estate, the existence of a state law prohibiting a transfer of assets from the estate to the beneficiaries (prior to a court decree) did not prevent such a transfer from constituting a distribution under IRC § 2032.

It remains unclear how the Service would apply its ruling in a state such as Texas, which has independent administration, and there is no order of the court distributing the estate or a state, again such as Texas, which has a muniment of title procedure in which there is no more than one debt; title passes automatically upon probate of the will and no personal representative is appointed to administer the estate. An estate making use of muniment of title might not be able to elect alternate valuation at least for probate assets. Yet the preparer could take the position that just as death of the decedent is not a distribution to a surviving joint tenant or tenant by the entirety, muniment of title is not distribution to "an heir or devisee to whom title in property passes directly under local law." Treas. Reg. §20.2032-1(c)(3).

[E] Application to specific assets

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

[F] Required information

If alternate valuation date is elected, the regulations require the following information be set forth on the return:

> (i) An itemized description of all property included in the gross estate on the date of the decedent's death, together with the value of each item as of that date;
>
> (ii) an itemized disclosure of all distributions, sales, exchanges, and other dispositions of any property during the 6-month period after the date of the decedent's death, together with the dates thereof; and
>
> (iii) the value of each item of property in accordance with the provisions of IRC § 2032.
>
> Interest and rents accrued at the date of the decedent's death and dividends declared to the stockholders of record on or before the date of the decedent's death and not collected at that date shown separately. Treas. Reg. §20.6018-3(c)(6).

[G] Required attachments

The executor shall file with the return evidence in support of any statements made by him in the return as to distributions, sales, exchanges, or other dispositions of property during the 6-month period that followed the decedent's death. If the court having jurisdiction over the estate makes an order or decree of distribution during that period, a certified copy thereof must be submitted as part of the evidence. Treas. Reg. §20.6018-4(e).

[H] Alternate valuation and fiduciary duty

If alternate valuation favors one beneficiary over another, the executor can probably rely on obtaining the lowest over all estate tax liability as being the fiduciary duty and there is no reason for adjustments between the beneficiaries. But, it may be too trite to say that the executor owes a fiduciary duty to seek a lower estate tax where the alternate valuation gives a lower estate tax over all assets in the federal estate. Say the federal estate contains assets in the probate estate and in a QTIP marital trust established by the

decedent's predeceased spouse. Further, let us say that with alternate valuation the overall tax bill drops $10,000, but the probate estate pays $90,000 more in taxes and the QTIP trust pays $100,000 less in taxes. Does the executor owe a fiduciary duty to the QTIP trust? It appears to your author that the situation should be brought to the attention of the parties, and if the matter can not be settled by agreement, the executor should seek declaratory judgment from the probate court. Otherwise, out of its own pocket the executor may be paying the disappointed party the difference.

[I] Alternate valuation and disclaimers

The gross estate may be reduced by alternate valuation but with a will with a marital formula designed to reduce the estate taxes to zero, the requirement for alternate valuation that the combined estate and GST taxes be reduced will not be met. If the surviving spouse disclaims assets that had a higher value on the date of death than on the alternate valuation date, a small tax is created using date of death values and alternate valuation can be elected. Also, if the marital deduction amount goes to a QTIP trust, with a partial QTIP election a small tax can be created and alternate valuation elected. The requirements for a qualified disclaimer are discussed in the section "Disclaimers" in Chapter 3, entitled "Required Information." Partial QTIP elections are discussed in the section "Qualified Terminal Interest Property (QTIP) Trusts," in Chapter 17, entitled "Schedule M." An excellent discussion of this topic can be found at Dawkins, "Another Bite at the Apple: Using the Alternate Valuation Election to Restore a Credit Shelter Trust," *Probate & Property*, Jan/Feb 2002.

§2.05 *Valuation and basis*

Under IRC § 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.

[A] 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 § 1014(b)(6).

[B] 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.

There is no change in basis for income in respect of a decedent. In *Rollert Residuary Trust v. Commissioner*, 80 TC 619, the Tax Court held that the residuary trust had to report the entire amount of bonus installments it received as distributions from the estate as income in the year when received. The court held that there was no step-up in basis of the IRD received from the decedent's estate, even though the estate received a full deduction for the item as DNI.

[1] 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 § 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 § 691(c)(2).

In *Estate of Cherry v. U.S.*, 87 AFTR 2d 2001-814 (W.D. Kentucky 2001), the estate's proposed IRC § 691(c)(1)(A) computation of income tax deduction for the estate tax attributable to IRD was rejected because the estate failed to remove IRD as the first step in the hypothetical tax calculation and its attempt to avoid the marital share recomputation resulted in an IRC § 691 deduction exceeding IRD itself.

[2] Examples of income in respect of a decedent

These are examples of some typical IRD items:

1. Accounts receivable of a cash-basis individual.

2. Renewal commissions of insurance agents.

3. Stock options. IRD may arise upon post-death exercise. In PLR 200012076, the IRS ruled that the decedent's bequest of a nonqualified employer stock option to a charitable organization will result in income in respect of decedent under IRC § 691 to the charitable organization at the time the options are exercised by such charitable organization, not to the decedent's estate or the heirs or devisees.

> A private letter ruling (PLR) is only good for the taxpayer who requested the ruling. If a published PLR is helpful, file your own request for a PLR

4. Payments on installment sales contracts. 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.*, 39 Fed. Cl. 525, 526-527 (1997). 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 and State of Israel bonds.

9. Pensions and IRAs. Account balances for pensions and IRAs are IRD to the extent that contributions were from pretax income. Contributions net of income tax will retain on a dollar for dollar basis.

10. Annuity contracts.

11. Deferred lottery winnings.

[3] 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 returns. The preparer should consider separate listings for ordinary income, tax free income and capital gains.

[4] Valuation discounts for IRD

Because an asset that is IRD has less value to the non-charitable beneficiary because of the federal income tax liability associated with it as compared with an asset that is not IRD, some clever Form 706 preparers attempt to take a valuation discount in valuing the IRD item. Your author has heard, second hand, of instances in which such discounts were successfully taken on IRA accounts. Dennis I. Belcher, *Comment*, PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, Jan. 7, 2002 (Belcher commenting regarding another preparer in West Virginia, not himself, who took such a discount on an IRA and was successful, at least, in getting a closing letter from the IRS.) Yet such discounts are inappropriate and should not be taken even by the aggressive preparer, because such discounts are not consistent with the hypothetical willing buyer willing seller valuation principle.

An example clarifies why this is so. Say Child A was named as the beneficiary of decedent's IRA that contained on the date of death exactly $100,000. Child B was the survivor beneficiary on a CD jointly owned with decedent that was worth exactly $100,000 (no accrued, unpaid interest) on the date of death. Child A receives a check for the account balance in the IRA in the amount of $100,000 (disregarding any interest or dividends earned after the date of death and before issuance of the distribution), and Child B cashes in the CD and also receives a check in the amount of $100,000 (again disregarding any interest or dividends earned after the date of death and before cashing in the CD). Who received the better inheritance, assuming that neither was responsible for estate taxes on that child's inheritance? Obviously Child B received the better inheritance, because the CD is not IRD and it does not come with an income tax liability, but the IRA is IRD and it comes with an income tax liability that Child A must report and pay. Child B received a better inheritance than Child A, even though each received the same thing: a check in the amount of $100,000.

What will a willing buyer of Child B's check be willing to pay? The answer is $100,000. A bank will most probably be the willing buyer of the check and will pay Child B, the willing seller, exactly $100,000 for it. What would Child B expect as the willing seller in negotiating the check? Exactly $100,000. Now consider what a willing buyer of Child A's check will be willing to pay. Here again the bank as willing buyer will pay exactly $100,000 for the check. Just because Child A must pay an income tax liability does not change the fact that Child A as willing seller will expect to receive the full amount of the check. Assuming that Child A's income tax rate is 35%, that does not mean that Child A will be satisfied to receive just $65,000 from the bank when cashing the IRA distribution check.

The only discounts that possibly might be allowed would be the check cashing fee the bank may charge. Possibly the fact that Child A's bank would not charge such a fee when other banks with which A does not conduct business will, should still permit the discount because Child A's bank is a real bank and not the hypothetical willing buyer. This analysis may entitle you to a $5 to $15 discount when a check is received rather than actual currency. The discount is not worth the effort. There may be other instances in which IRD has significant transaction costs associated with its collection and liquidation that may give rise to a valuation discount, but there is never a proper discount for the income tax liability associated with IRD. Never.

The IRS will base its position that there is no discount on *Estate of Robinson v. Comm*., 69 TC 222 (1977), which dealt with the valuation of an installment obligation at death. That was exactly the position the Service earlier took in TAM 200247001. The TAM also stated that there would be no discount for lack of marketability due to processing delays. *See also* Choate, *Estate Tax Valuation of Retirement Benefits*, TRUSTS AND ESTATES, May 2002, p. 16.

Some preparers mistakenly apply the discount for built in capital gains tax, discussed below in the *Davis* and *Eisenberg* cases, to the IRA, but as the discussion above shows there is no built-in gain and associated tax liability that is transferred to the buyer of the IRA. In *Estate of Louis R. Smith v. U.S*., 300 F. Supp. 2d 477(S. D. Texas 2004) the U.S. District Court on a motion for summary judgment denied an estate tax refund based on a 30 percent discount on retirement plans for income taxes due upon distribution, basing its conclusion by applying the willing buyer/willing seller test to the retirement account assets rather than to the accounts in the hands of the decedent. The court noted that IRC § 691(c) ameliorates the effect of double taxation by allowing an offsetting income tax deduction in the amount of the estate tax attributable to the asset.

The district court decision was affirmed by the Fifth Circuit.

> The Estate's argument is exactly the kind of beneficiary -- specific inquiry, with the added feature of speculation on the future, but the hypothetical willing buyer willing seller test precludes.
>
> The Estate, however, contends there is a recent trend, as evidenced by several cases, of considering potential tax liability in valuation. See Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002); Estate of Jamison, 267 F.3d at 366; Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1998): Estate of Davis v. CIR, 110 TC 530, 1998 WL 345523 (1998). In those cases, the estate asset at issue with stock in a closely held corporation, and the court was faced with the question whether the capital gains tax that would be payable upon the sale of assets held by the corporation would factor into the fair market value of the corporation's stock. See Dunn, 301 F.3d at 339; Estate of Jameson, 267 F.3d at 366; Eisenberg, 155 F.3d at 50; Estate of Davis, 110 TC at 530. As the government urges, these cases are distinguishable. First, this case involves a different sort of asset i.e. Retirement Accounts containing marketable stocks and bonds. Thus, the rationale in those cases, that a hypothetical buyer would discount price of stock in a closely held corporation to reflect the capital gains taxes that would be payable by the buyer in the event of a subsequent liquidation of the corporation, is wholly in applicable here. Second, while the stock considered in the above cases would have built-in capital gains even in the hands of a hypothetical buyer, the Retirement Accounts at issue here would not constitute income in respect of the decedent in the hands of the hypothetical buyer. Income in respect of a decedent can only be recognized by (1) the estate; (2) the person who acquires the right to receive the income by reason of the decedent's death; or (3) the person who acquires the right to receive the income by bequest, devise, or inheritance. 26 USC §691(a)(1). Thus, a hypothetical buyer could not buy income in respect of a decedent, and there would be no income tax imposed on a hypothetical buyer upon the liquidation of the accounts. Third, as we have seen, Congress has provided relief, in §691(c) from the income tax that would be imposed on the decedent's beneficiaries in the form of a deduction for the estate taxes paid with respect to the inclusion in the gross estate of the Retirement Accounts. In contrast, in the case of closely held corporate stock, the capital gains tax potential survives to transfer to an unrelated third party, and Congress has not granted any relief from the secondary tax.

[5] 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. For example, the basis of feed for livestock will be an expense or deduction in respect of a decedent and deductible on the Form 706 as well as the Form 1041.

[6] 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 at 356.

[C] 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 § 6662, discussed above, may impose additional tax where an underpayment of tax is attributable to an overvaluation statement.

[D] Depreciation and basis

Depreciated assets receive a new basis and depreciation can begin anew in the hands of the decedent's beneficiaries. When an estate is not paying estate taxes, because of marital or charitable deductions or because of special use valuation of farm or business, a high valuation of depreciable assets will provide income tax benefits. For example, farm equipment that the decedent depreciated to zero can be depreciated again.

Depreciation of rental properties will be based upon the new stepped-up values.

Caution must be exercised so as to not overstate the value and create a valuation overstatement resulting in penalties for understating the income tax liability. In Rev. Rul. 85-75, 1985 CB 376, the IRS ruled that the overvaluation penalty under IRC § 6659, applies to an income tax return taking a depreciation deduction if the taxpayer as beneficiary of an estate adopts an overstated amount reported on an estate tax return.

[E] 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.

[F] Property acquired from transferee

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. IRC § 1014(3).

Say the assets were acquired by the decedent by gift within one year prior to death and pass to a non-marital testamentary trust in which the donor is one of several beneficiaries or even the primary beneficiary. This fact situation does not appear to invoke Section 1014(e) whether the donor is the decedent's spouse or another beneficiary.

Say the assets were acquired by the decedent by gift from decedent's spouse within one year prior to death and pass to a QTIP marital deduction trust for the donor spouse. The QTIP trust has remainder beneficiaries and the assets have not passed in fact back to the donor. The preparer may be involved in determining what assets will be funded to the donor spouse through a QTIP trust and what will be funded to other beneficiaries and the preparer will be involved in determining whether to make the QTIP election.

IRC § 1014(e) was part of ERTA and the Blue Book, page 265 states:

> Reasons for Change . . .
>
> Because the Act provides an unlimited marital deduction and substantially increased the unified credit.

This indicates a link between the unlimited marital deduction and IRC § 1014(e). The IRS argument would be that you only get a marital deduction for property that "passes from the decedent to" the surviving spouse. IRC § 2056(a). A marital deduction is available for the full value of the property passing into a QTIP trust, because "such property shall be treated as passing to the surviving spouse." IRC § 2056 (b)(7)(A)(i). IRC § 1014(e) applies to any appreciated property "acquired from the decedent by (or passes from the decedent to)" the donor. Both sections use the phrase "passes from the decedent to." If the QTIP trust is elected for the marital deduction, IRC § 1014(e) applies. That was the holding of PLR 9026036 which states that if the donee spouse dies within one year of the gift and the property passes to the donor spouse in a QTIP disposition only that part of the gift attributable to the donor spouse's income interest is subject to IRC § 1014(e). The same taxpayer received the same ruling on this point in PLR 9321050. Richard Covey appears to agree with these private letter rulings, *Practical Drafting*, p. 4788.

The contrary argument may be that there is no revenue ruling or regulation that addresses this situation even after 20 years since ERTA and the IRS argument is not the most reasonable reading of the statutes. Income tax sections are not read in *pari materia* with the income tax rules. In the absence of a revenue ruling or a regulation, an estate attempting to obtain a full step up in basis under these facts need not make a disclosure on the Form 706. Your author takes no position on whether disclosure may be required on the donor's Form 1040 (or the QTIP Form 1041) upon sale of the assets.

Say the donor spouse makes the gift to the donee spouse by a QTIP disposition and after the donee spouse's death the property continues in further trust for the donor spouse in another QTIP disposition. Covey thinks that you get the same result under IRC § 1014(e) as with an outright gift to the donee spouse. *Id.*

[G] 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.

[H] Presumptive basis

A beneficiary should retain a copy of the Form 706 because it is the best evidence of the basis of inherited assets, but for inherited assets it only gives the presumptove basis. The IRS National Office has ruled that a beneficiary of a decedent's estate who inherited stock of a closely held corporation was not estopped from claiming a stock basis for income tax purposes that was different than the value used for federal estate tax purposes. In Rev. Rul. 54-97, 1954-1 CB 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. The general rule of Treas. Reg. § 1.1014-3(a) is merely a rebuttable presumption and may not be conclusive in the face of clear and convincing evidence to the contrary. Courts have not estopped beneficiaries from repudiating estate tax values where the executor and beneficiary are not in privity. TAM 199933001.

[I] 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 at 355.

§2.06 *Valuation discounts*

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

[A] 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. Solid logic supports the discount. The number of willing buyers is limited, resulting in an extended period to market the interest. There is no established market for partial interests, so the discount reflects lack of marketability. There is a qualitative difference in ownership rights between a partial interest and the whole.

When dealing with a co-tenancy in real property look to applicable state law to determine the competing rights of the cotenants. If each cotenant has a right of occupancy and to collect the rents, then those rights should effect the amount of the discount to be applied.

[1] Costs of partition

The IRS has attempted to limit the factional interest discount to the costs of a partition suit. *Williams v. Comm*, TC Memo 1998-59. *See, Estate of Horace K. Fawcett v. Comm*., 64 TC 889 (1975), acq., 1978-2 CB 2. The IRS obtained an opinion from a lawfirm in Seguin, Texas, 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 *Samuel J. LeFrak*, TC Memo 1993-526; *Estate of Alto B. Cervin*, TC Memo 1994-550; and *Estate of Bonnie I. Barge v. Comm*., TC Memo 1997-188. The IRS has attempted to resuscitate partition costs in TAM 199943003. The appropriate fractional interest discount is a matter of fact to be resolved on the basis of the entire record. One method for determining the fair market value of an undivided interest in property, according to the IRS, is to value the fee, multiply the value of the fee by the undivided interest, and subtract out the share of the costs of partition allocable to the undivided interest. This IRS position fails to take into consideration the time value of money and the partition process may require protracted negotiations or protracted litigation or both.

A 25 percent lack of marketability discount was applied to commercial property. The amount of discount was neither as low nor as high as suggested by the experts, but it was supported by the factor analysis for fractional interests. The discount allowed was not limited to the costs of partitioning the property because such a discount did not account for lack of control and lack of marketability. *Estate of Eileen Kerr Stevens v. Comm*, TC Memo 2000-53.

Schiller, *Piercing the Partition Fiction for Fractional Interest Valuation*, TRUSTS & ESTATES, July 2000, p. 42, discusses the tax court's treatment of partition in two recent cases, *Estate of Eileen K. Brocato v. Comm*., TC Memo 1999-424 and *Estate of Busch v. Comm*., TC Memo, 2000-3 and argues that partition is a forced sale and its use violates the strictures of Treas. Reg. §20.2031-1(b) that the value of property is not to be determined by a forced sale price. The article discusses partition discount litigation as well as preparation of the appraisal report. The appraiser should consider "all elements of the costs and expense, delay and marketability discount of partition sales as part of an analysis of the various factors that affect fractional interest value." *Id*. at 47.

[2] Discount well-established

A discount for lack of marketability for a fractional interest is well-established. In *Propstra v. U.S.*, 680 F.2d 1248, 1253 (9th Cir. 1982), 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. See below the discussion of family attribution.

[3] 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 (CCH) 1425 (1982), 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.

[4] Factors considered

Various factors will determine the magnitude of the discount. A small fractional interest (say one-tenth) will generally deserve a greater discount than an eight-tenths interest. The number of other partial owners may be determinative; more owners could be a plus or a negative depending upon the type of property. Divisibility of the real property may have two aspects – actual partition of the subject property (such as ranch or farm land) or division of benefits and management (such as for a commercial property or residential apartments). Some property, such as a residential lot, may be difficult to divide under both aspects. The perceived difficulty of marketability may also affect the discount.

Estate of Berg, 61 TCM (CCH) 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*. 2953, reversed on other grounds 976 F.2d 1163 (8th Cir. 1992)

[5] 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 farm or ranch.

[B] 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.

[1] Closely held businesses

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.

[2] Promissory notes

There is no market for unsecured promissory notes, so they can carry a discount for lack of marketability. Discounting promissory notes is discussed in Chapter 7.

[C] Lack of control or minority discount

In addition to the lack of marketability discount that is available for virtually every closely held business interest, a lack of control or minority discount is available for closely held business interests that do not carry the right to control business decisions.

[1] 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 discount. *See*, Rev. Rul. 93-12, 1993-1 CB 202. Focusing upon the other partial interest owners as the potential buyers violates the rule that the sale involve a hypothetical buyer.

[2] 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 TCM (CCH) 645 (1990), transfers shortly before death were disregarded and the decedent's interest was valued as if she retained a majority interest. The judge seemed to find that there was a transfer in contemplation of death in the "penumbra" of the Internal Revenue Code. *Estate of Bright v. U.S.*,658 F.2d 999 (5th Cir. 1981), was distinguished.

[D] 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. Comm.*, 110 TC 530 (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, Eisenberg v. Comm.*, 155 F.3rd 50, 58 & n. 14 (2nd Cir. 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.

See the discussion above in the section entitled "Valuation discounts for IRD," as to why no similar discount is permitted for IRD.

[E] Family limited partnerships

The preparer of a return that will include the value of a family limited partnership interest held by the decedent must carefully review recent cases dealing with family limited partnerships to know the range of discounts being approved and to address problems present in the decedent's interest that may have been discussed in prior cases. Valuation issues and inclusions in decedent's estate continue to develop in the various court cases already decided and cases in which decisions are pending. Yet, the discussion in secondary sources goes to the planning process in preparing new family limited partnerships and not the reporting of family limited partnerships on an estate tax return. That is to be expected. Until there is a definitive case saying that the partnership is to be disregarded in valuing the underlying assets, family limited partnerships will continue to be reported on estate tax returns with discounts.

[F] 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 CB 237.

[G] Time-value of money

A discount for the time value of money is appropriate, but the valuation experts must provide the discount factor. In *Trompeter v. Comm.*, TC Memo 1998-34, the Tax Court was faced with determining how to value decedent's preferred stock that was subject to mandatory redemptions. The court first found the amounts that the estate would receive on the three redemption dates and then applied a "reasonable discount rate of 4 percent" to each redemption amount to ascertain its present value on the valuation date. This value determined by the court was greater than the value argued for by the IRS, so the court accepted the IRS value. On appeal, TC No. 11170-95 (9th Cir. 2002), the appeals court remanded for the Tax Court to clarify its methodology and to document its rationale for its present value calculations, because the Tax Court did not specify why it elected to discount the payments at four percent or why such a rate was "reasonable." The appeals court cited *Estate of Mitchell v. Comm.*, 250 F.3d 696, 704 (9th Cir. 2001): "Because the [discount] range is unsupported by the testimony of any of the experts, singularly or together, it is unclear whether the Tax Court's combined discount actually falls within any particular range that might be supported in the record."

[H] Additional information

More information on valuation discounts can be found in Hall and Polacek, *Strategies for Obtaining the Largest Valuation Discounts*, ESTATE PLANNING, Jan. Feb, 1994 at 38.

§2.07 *Special valuation rules*

IRC Chapter 14 includes special valuation rules for valuing certain transfers to family members. These special rules will be discussed with respect to assets to be reported on the various schedules. The Instructions make this brief mention of these exceedingly complex rules.

> Section 2701 deals with the transfer of an interest in a corporation or partnership while retaining certain distribution rights, or a liquidation, put, call, or conversion right.
>
> Section 2702 deals with the transfer of an interest in a trust wile retaining any interest other than a qualified interest. In general a qualified

interest is a right to receive certain distributions from the trust at least annually, or a noncontingent remainder interest if all of the other interests in the trust are distribution rights specified in section 2702.

Section 2703 provides rules for the valuation of property transferred to a family member but subject to an option, agreement, or other right to acquire or use the property at less than FMV. It also applies to transfers subject to restrictions on the right to sell or use the property.

Finally, section 2704 provides that in certain cases the lapse of a voting or liquidation right in a family-owned corporation or partnership will result in a deemed transfer.

These rules have potential consequences for the valuation of property in an estate. If the decedent (or any member of his or her family) was involved in any such transactions, see Code sections 2701 through 2704 and the related regulations for additional details.

[A] Buy sell agreement

The effect of IRC § 2703 on buy-sell agreements was addressed in *Estate of Blount*, TC Memo 2004-116 (Mau 12, 2004). At issue was an agreement by the decedent with a company that he had a controlling interest and a unrelated ESOP. The agreement was made prior to October 18, 1990; significant because IRC § 2703 only applies to restrictive agreement entered into or substantially modified after that date. But in 1996, without the ESOP's consent the decedent and the corporation modified the agreement changing the price and terms under which the corporation would redeem the decedent's shares upon his death. The modified price was substantially below the price that would have been payable pursuant to the unmodified agreement. The court failed to recognize the modified price as establishing value for federal tax estate purposes because decedent had the unilateral ability to modify the agreement rendering the agreement not binding during the decedent's life as required by Treas.§20.2031-2(h). (ii)the 1996 modification was a substantial modification, and (iii) the modified agreement is disregarded for purposes of IRC § 2703. (b)(3), which requires that the terms of the agreement be comparable to similar arrangements entered into by persons in an arms length transaction. The last finding occurred despite the fact that the remaining shareholders were unrelated to the decedent, creating a strict evidentiary standard t satisfy the "comparability test".

Smith III v. Comm., 94 AFTR 2d 2004-5283 (W.D. Pa. June 30, 2004), addressed that the effect under IRC § 2703 in valuing a family limited partnership of a specific transfer restriction in an FLP agreement that required transfers be subject to a right of first refusal that permitted payment with a 15-year installment note bearing interest at the long term "applicable federal rate." The case suggests a strict evidentiary standard for satisfying the "comparability test".

For an exhaustive review of the "testamentary devise" test used as a factor in determining if the price of a buy sell agreement is binding on the IRS see Estate of True v. Comm., 390 F.3d 1210 (10th Cir. 2004), which reviews every case about buy sell agreements in the last 10 to 15 years. In this particular case, which pre-dated Section 2703, the taxpayer argued that the court was applying the comparability test in Section 2703 retroactively. The court responded that the comparability test was just a way of showing that the agreement was not a testamentary device and that Section 2703 did not really change the law. The court overruled its prior decision in Broderick v. Gore, 224 F.2d 892 (10th Cir. 1955) in light of developing case law and other courts and because of a change in regulations after the Brodrick case. In Brodrick the court held that if the buy sell agreement was binding and if the stock was sold at the price set in the agreement that the sale price fixed the value for estate tax purposes. In True the court looked at the number of factors: the health and the age of the decedent when entering into the agreement; the lack of regular enforcement of its terms; the nature of the corporation's assets and whether any assets were excluded under the formula; arbitrary methods in selecting terms; if the price formula was based on an appraisal; lack of negotiating in reaching the agreement; whether all parties were equally bound; whether there was a provision for adjustment or revaluation of the price; whether there is evidence that the agreement was just part of the decedent's testamentary plan.

§2.08 *Mistaken value*

Asset values reported on the schedules are taken as an admission of their fair market value by the executor. The executor must prove that, as originally reported, it was incorrect. *See, Rabenhorst v. Comm.*, 71 TCM (CCH) 2271 (1996); *Estate of Pillsbury v. Comm*., 64 TCM (CCH) 284 (1992). Where there is some question as to value, the author recommends including that fact in the item description to make it easier to have the revised value accepted by the IRS. It is better to report no value or an exceedingly low value when in doubt than to err on the high side.

§2.09 *Approximation of values*

In *Trompeter v. Commissioner*, TC Memo. 2004-27; No. 11170-95, on remand from the Ninth Circuit, 279 F.3d 767 (9th Cir. 2002), the Tax Court was to articulate sufficiently its basis for ruling an

omitted assets. The court commented on its previous opinion.

> We proceeded to make an approximation of the fair market value of assets omitted from the taxable estate, recognizing that valuation is not an exact science and that the task before us was difficult in that the co-executors had concealed information and assets from their accountants, respondent, and this Court. *Id.*

The Tax Court confronted a dispute as to both fair market value and inclusion in the estate. The co-executors admitted removing from decedent's residence some of the unreported assets but denied the existence of others. While the government never recovered any of those assets, it nevertheless established to the satisfaction of the court that they existed and were includable in the taxable estate. The government did so "through the introduction of credible testimony and documentary evidence that includes receipts and checks from purchases made by the decedent." *Id.* The court also found that those assets had not been relinquished by the decedent. The court went on to determine the existence of specific unreported assets and then to determine their fair market values. The court used testimony, appraisal, and auction estimates and results to interpolate values for gems, jewelry, furniture, a music collection, cash at home, coins, rugs, jade and ivory.

The question of fair market value was linked to their inclusion in the estate.

> The decedent was a longtime, avid collector of various valuable items that included specially minted, limited edition gold coins, precious gemstones, expensive jewelry, exquisite rugs and furniture, and guns. He was a wealthy man who enjoyed the finer and more expensive things in life, and he had the financial means to fulfill his desire of collecting only the best pieces of the items which he collected. He was an astute and shrewd businessman who was very knowledgeable about and proud of his collections, and he received much enjoyment flaunting his possessions before others when he entertained at home or was a guest at someone else's home.
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> ***
>
> In early 1991, the decedent learned that he had terminal cancer, and he relayed this information to the co-executors. At that time, Gonzales, the decedent's oldest daughter, began discussing with the decedent the specifics of the assets which he owned. Gonzalez, and to a lesser extent Polachek, became knowledgeable of the specifics of the decedent's vast wealth, and Gonzalez in conjunction with Polachek deliberately undertook to maximize their receipt of that wealth by, among other things, undervaluing his assets and excluding assets from the taxable estate. *Id.*

While there were issues as to exactly what was included, the court in its opinion sets forth with detail, as requested by the Ninth Circuit, its reasons for valuation of the assets.

3 REQUIRED INFORMATION

§3.01 *First three pages*

For any estate required to file a return, the first three pages must be completed and filed. Page 3 contains questions that are required to be answered, and based on the answers to these questions, certain schedules may be required.

§3.02 *Part 1. Decedent and executor information*

This section must be completed on each return.

Items 1a and 1b. Decedent's name. Use the name under which the Decedent filed income and gift tax returns, even though it may not be the same name on the will. Consider attaching an explanation for the reason for the difference in names. When preparing the return it is too late to redraft the will, so it is recommended that the will itself contain all the other names used by the testator or testatrix in legal documents.

Item 2. Social security number. The Instructions admonish that you must use the number assigned specifically to the decedent and cannot use the spouse's number. If the decedent does not have a social security number, the executor should obtain one. Instructions, p. 3.

Item 3a. Decedent's legal domicile. Several important consequences depend upon the decedent's domicile. The laws of decedent's domicile will govern the disposition of decedent's estate. The domicile will govern which U.S. District Court has venue in the event of a tax dispute filed in a federal district court, and in the event of an appeal from either the district court or the U.S. Tax Court, the rules of which circuit apply. Domicile at death plus the number of years at that domicile, will be strong indicators of the type of marital property the married decedent owned, separate or community. Domicile also determines the appropriate time zone for determining the date of death.

Item 3b. Year domicile established. Year of domicile works with domicile and marital status to indicate the type of property the estate should contain, community or separate.

Item 4. Date of birth. This date will be used to determine if a non-relative beneficiary is 37 ½ years

younger for GST tax purposes, as well as calculating the value of certain reversions and remainders.

Item 5. Date of death. Determining the date of death is discussed in General Matters. See the discussion there. Determining and reporting the correct date of death is important for determining due dates, statute of limitations and the tax laws applicable to the decedent's estate.

Item 6a. Executor's name. This item is completed with the name of the executor to be contacted by the IRS. The names of other executors, their addresses and social security numbers (if an individual) are to be listed on an attached sheet. *Id.* The Instructions do not say so but usually the extra sheet contains the penalties of perjury statement and the signature line for the extra executors.

Item 6b. Executor's address. If the executor's address changes, the instructions state that Form 8822 should be used. This address can be a P.O. box or a business address.

Item 6c. Executor's social security number. The executor's social security number is required only where the executor is an individual. For a corporate executor no federal taxpayer ID number is required. The IRS may check the executor's social security number to make sure that claimed compensation is eventually reported on the executor's personal income tax return.

Item 7a. Name and location of court. The name of the court, the county and the state of location are usually sufficient. The information may be used by the IRS to review the inventory or the file in the court clerk's office.

Item 8. Certified copy of will. A certified copy of the will must be attached if the decedent was a citizen or resident and died testate. Treas. Reg. §20.6018-4(a). If a certified copy cannot be obtained, attach a copy and an explanation. Instructions, p.3.

When making a copy for the state, clients, the firm, etc., stamp the copy of the certificate, preferably in red or blue ink, "COPY."

§3.03 *Whole dollars*

Values reported on the return may be reported in dollars and cents or in whole dollars. IRC § 6102. The regulations specifically state that whole dollar treatment applies only to amounts required to be reported on a return and does not apply to items that must be taken into account in making the computations necessary to determine such amounts, Treas. Reg. §301.6102-1(c), such as life estates and remainders.

§3.04 *Part 2. Tax computation*

The Instructions clearly state in bold "You must complete the Tax Computation." *Id.*

Line 1. Total gross estate less exclusion. This figure comes from Line 12 of the Recapitulation; Line 10, the total gross estate less Line 11, the qualified conservation easement exclusion. If this number exceeds the filing threshold, then a return must be filed, regardless of the amount of the deductions on the next line. Even if Line 1 does not reach the filing threshold, a return may be required if adjusted taxable gifts on Line 4 lift the taxable estate, Line 3, past the filing threshold, and also if Line 10 of the Recapitulation meets the filing threshold. The Instructions state that if alternate valuation is elected then this is the figure from the "Alternate value" column. When alternate valuation is not elected, this will be the only figure on Line 12 of the Recapitulation.

Line 2. Total allowable deductions. This figure comes from Line 23 of the Recapitulation.

Line 3. Taxable estate. For estates with adjusted taxable gifts, this could be substantially less than the filing threshold, and could even be a negative number, yet a return is required. For estates without adjusted taxable gifts, this amount will be the amount on which the estate tax will be paid.

Line 4. Adjusted taxable gifts. The full description of this line contains instructions as to this number.

> Adjusted taxable gifts (total taxable gifts (within the meaning of Section 2503) made by the decedent after December 31, 1976, other than gifts that are includable in decedent's gross estate (section 2001(b)).

For this line, as well as Line 9, three worksheets are included in the instructions, but all of the decedent's gift tax returns must be located first. Instructions, p. 4. See the section below entitled "Locating gift tax returns." Despite the drastic changes made for taxable gifts after 1976, returns for gifts prior to 1977 must also be located.

The instructions state that the amount of gifts can usually be derived from the returns with certain adjustments.

The careful estate tax return preparer, in addition to reviewing the returns to make any of these adjustments, will review to see if the gift tax returns were properly prepared and filed. Amended gift tax returns to correct incorrectly filed returns may be in order. Query if the estate tax return preparer must amend incorrectly prepared returns that favor the estate. Does it make a difference if the return was prepared by the preparer or by another? Your author has not located any authority on this point.

If any of the returns were audited by the IRS, you should use the amounts that were finally determined as a result of the audits.

> Amounts must be included for any gifts in excess of the annual exclusion made by the

> decedent (or on behalf of the decedent under a power of attorney) but for which no Forms 709 were filed by the decedent. The instructions for Lines 4 and 9 do not say so, but if gifts were not reported or returns were not filed by the decedent, it is the duty of the executor to file those returns. The instructions do state that the executor must make a reasonable inquiry as to the existence of any such gifts.
>
> Instructions, p. 4.

Taxable gifts made after 1976 and reported on Schedule G as included in the gross estate are subtracted.

Gifts that qualify for "special treatment of split gifts" are not included in the gifts total if they meet all of the following conditions:

(1) The decedent's spouse predeceased the decedent;

(2) The decedent's spouse made gifts that were "split" with the decedent under the rules of section 2513;

(3) The decedent was the "consenting spouse" for those split gifts, as that term is used on Form 709; and

(4) The split gifts were included in the decedent's spouse's gross estate under section 2035.

Trompeter v. Comm., TC Memo 1998-35, was a case in which the Tax Court rejected an IRS effort to increase the decedent's adjusted taxable gifts to reflect a "post-death gift" made to decedent's former spouse. Decedent and his former wife as part of sale of a closely held business placed funds in separate escrow accounts for state corporate income taxes. At the end of the audit, the wife's obligations exceeded the amount in her escrow account and the decedent's executors permitted her difference to come from the estate's funds. The estate later permitted the payment to be an offset against a settlement of the spouse's claim that the decedent had committed fraud when they divorced. The IRS and the Tax Court agreed that the former spouse lacked a bona fide claim against the estate, and the IRS claimed that the offset was an adjusted taxable gift made by the co-executors on behalf of the estate. The Tax Court ruled that the estate did not make a gift, the value of the loaned funds was included in the decedent's gross estate and that no further addition to the decedent's estate was warranted.

But the Tax Court in *Trompeter* did increase the decedent's adjusted taxable gifts in agreement with the IRS disallowance of various bad debt deductions claimed by the decedent on his Federal income tax return. The Tax Court agreed that certain "loans" were not bona fide debts but advances to friends solely for reasons other than to make a profit and not entitled to an income tax deduction for a nonbusiness bad debt that becomes worthless during the calendar year, under IRC § 166(d). After applying the annual exclusions for each donee, the decedent's adjusted taxable gifts were increased.

Line 5. Add. This label does not adequately indicate that the amount on this line is the amount upon which the tentative tax will be calculated. A high number here will indicate an estate with a substantial tax liability.

Line 6. Tentative tax. The tables show how the tax will be calculated depending upon the year of death under the law after the Economic Growth Tax Relief and Reconciliation Act of 2001.

Armed forces combat deaths. Considering that the federal estate tax has historically been seen at least at implementation as an effort to raise taxes for war, it seems appropriate that a decreased tax be imposed upon those who in Lincoln's words "gave the last full measure of devotion" as an armed forces combat death. The normal estate tax calculated under IRC § 2001 is replaced by a tax equal to 125% of the maximum state death tax credit applicable to the estate under 2011(b). The states, until 2002, received 80% of the tax so calculated and the Federal government 20%. IRC § 2201.

Terrorist deaths. The Victims of Terrorism Tax Relief Act of 2001 applied IRC § 2201 to the estates of individuals who died as the result of wounds or injuries incurred as a result of the terrorist attacks against the United States on April 19, 1995 (Oklahoma City bombing) and September 11, 2001. For detailed information see IRS Publication 3920, Tax Relief for Victims of Terrorist Attacks. Also included are estates of those who die as a result of illness incurred as a result of an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002. The executor will be considered to have made the election to apply revised IRC § 2201 by completing the return following the general rules with these modifications:

(1) Write "Section 2201" at the top of page 1 of the return.

(2) Figure the tax on lines 6 and 9 using the special tax rate schedule which is on page 25 of these instructions.

(3) Skip lines 7a-c and enter the amount from line 6 on line 8.

Line 7. Prior gift tax payable. Here the amount of gift taxes paid on gifts made after December 31, 1976 is entered. This amount is subtracted from the tentative tax to determine the amount due, thus acting like a credit on taxes to be paid. This amount should not be understated. The instructions clearly state that the amount to be entered on this line is a hypothetical figure based only on gifts made after

1976 and used to calculate the estate tax and does not necessarily reflect tax actually paid by the decedent. The full title of this line indicates the complications that are possible. Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includable in the decedent's gross estate (see instructions). The instructions contain a worksheet to calculate this amount independent of the amounts shown as paid on the gift tax returns.

Table 8
Estate Tax Table, Under EGTRRA 2001

From To	2001	2002	2003	2004	2005	2006	2007	2008	2009
0 $675,000	0	0	0	0	0	0	0	0	0
$675,000 $750,000	0 37%								
$750,000 $1,000,000	$27,750 +39%								
$1,000,000 $1,250,000	$1225,250 +41%	0 41%	0 41%						
$1,250,000 $1,500,000	$227,750 +43%	$102,500 +43%	$102,500 +43%						
$1,500,000 $2,000,000	$335,250 +45%	$210,000 +45%	$210,000 +45%	0 +45%	0 +45%				
$2,000,000 $2,500,000	$560,250 +49%	$435,000 +49%	$435,000 +49%	$225,000 +48%	$225,000 +47%	0 +46%	0 +45%	0 +45%	
$2,500,000 $3,000,000	$805,250 +53%	$680,000 +50%							
$3,000,000 $3,500,000	$1,070,250 +55%								
$3,500,000 $10,000,000									0 45%
$10,000,000 $17,184,000	$4,920,250 +60%								
$17,184,000 and higher	$9,230,650 +55%								

Taken from a table originally prepared by Ronald Aucutt.

a. Calendar year or calendar quarter	b. Total taxable gifts for prior periods (from Form 709, Tax Computation, line 2)	c. Taxable gifts for this period (from Form 709, Tax Computation, line 1) (see below)	d. Tax payable using Table A (see below)	e. Unused unified credit (applicable credit amount) for this period (see below)	f. Tax payable for this Period (subtract col. e from col. d)
Total pre-1977 taxable gifts. Enter the amount from line 1, Worksheet TG					

Table 9 Applicable Credit Amount Under the 2001 Act				
Year	Exemption Equivalent	Applicable Credit Amount	Begin-ning Rate	Top Rate
2001	$675,000	$220,550	37%	55% (60%)
2002	$1,000,000	$345,800	41%	59%
2003	$1,000,000	$345,800	41%	49%
2004	$1,500,000	$555,800	45%	48%
2005	$1,500,000	$555,800	45%	47%
2006	$2,000,000	$780,800	46%	
2007	$2,000,000	$780,000	45%	
2008	$2,000,000	$780,000	45%	
2009	$3,500,000	$1,455,800	45%	
2010	----	----	0	

For each year after 1976 you are to determine and calculate the following:

a. The calendar year in which gifts were made.

b. Total taxable gifts for prior periods. Because gift taxes (but not estate taxes) are calculated giving due consideration to gifts prior to 1977, to calculate the proper amount for this line pre-1977 gift tax returns must be located; however, the "tax payable" on pre-1977 gifts are not included in the "tax payable" figure being calculated. The instructions again require including any taxable gifts in excess of the annual exclusion that were not reported on Form 709.

c. The taxable gifts for this period. Again the figure must include taxable gifts in excess of the annual exclusion that were not reported on Forms 709.

d. Tax payable using Table A of the instructions. The tax payable is calculated using Table A as it applies to the year of the decedent's death rather than to the year the gifts were actually made. This amount (column d) is the difference in subtracting the "tax payable" on the amount in column b. from the tax payable on the amounts in columns b and c added together. If the amount in columns b and c combined exceeds $10 million for any calendar year, then the tax payable is calculated using the Form 709 revision in effect for the year of the decedent's death.

e. Unused unified credit (or applicable credit amount) for the period. This amount is the unified credit on the applicable credit amount in effect for the year the gift was actually made.

f. Tax payable for the period (subtracting e from d). The sum of all amounts in column f is entered on Line 9 after two adjustments. You subtract the gift taxes paid by the decedent on gifts that qualify for "special treatment" in the calculation of Line 4. Then you add the gift tax paid by decedent's spouse on split gifts included in Schedule G.

Line 8. Gross estate tax. This is the gross estate tax before any applicable credits.

Line 9. Maximum unified credit. This is the applicable credit amount against federal estate taxes. Beginning in 2004 the federal estate tax and gift tax are uncoupled and it will no longer be a "unified" estate and gift tax credit. Table 9, Applicable Credit Amount Under the 2001 Act, sets forth the applicable credit amount depending upon the year of death.

Line 10. Adjustment to unified credit. The Tax Reform Act of 1976 unified the federal estate and gift tax rates and brought in the unified credit. Prior to unification, each taxpayer could make taxable gifts of up to $30,000 without paying gift tax by using the specific exemption. This gift tax exemption was going to be lost with the new unified credit, so the Tax Reform Act of 1976 provided that the new unified credit was to be reduced by 20% of the specific exemption used from September 9, 1976 (the date the provision was added to the tax bill) to December 31, 1976.

If the decedent made no gifts between September 8, 1976 and January 1, 1997 (exclusively) or if the decedent made gifts during that period but did not claim the specific exemption then enter zero.

Line 22. Prior payments. This will be payments paid on a prior estate tax return filed prior to a timely filed final estate tax return or as in the usual case, tax paid with an extension request to file the return or pay the tax. The attached statement usually will be a statement referring to the extension request and a copy of the check by which the tax was paid.

Line 25. Balance due. If a refund is due, the refund will carry interest at the federal rate. Payment is usually made by a personal check, not a cashier's check, certified check or money order because the estate will want to retain the float.

§3.05 *State death tax credit.*

Line 13 of the returns for decedents dying prior to 2005 was the state death tax credit. The state death tax credit was 75% of the full credit for decedents dying in 2002, 50% of the full credit for decedents dying in 2003, 25% of the full credit for decedents dying in 2004, and is replaced by a deduction for state death taxes for decedents dying after 2004. There is no deduction permitted during the period the credit is gradually reduced but not yet reduced to zero.

§3.06 *Signatures*

[A] Executors

See previous discussion regarding the required signature by the executors.

[B] Preparers

The paid preparer, other than the executor, is also required to sign the return. This is no small matter, given the IRS statement on standards of conduct for filing returns. Section 10.34 of Treas. Circular 230 is set forth in the text box below.

§3.07 *Part 3. Elections by executor*

This is where the executor makes certain elections, termed as such, as to the whole return.

[A] Alternate valuation elected?

Alternate valuation is discussed in the section "Alternate valuation" of "Chapter 2, Valuation." Some preparation software will not let the preparer enter alternate valuation information unless this is checked "yes." Also, some software contains failsafes where a "yes" answer when the return does not qualify (*i.e.* no decrease in tax with alternate

Excerpt from Treas. Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service.

§10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.

(a) Standards for conduct – (1) Realistic possibility standard. A practitioner may not sign a return as a preparer if the practitioner determines that the return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous, and is adequately disclosed to the Service. A practitioner may not advise a client to take a position on a return, or prepare the portion of a return on which a position is taken, unless –

(i) The practitioner determines that the position satisfies the realistic possibility standard; or

(ii) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 66621 of the Internal Revenue Code of 1986 by adequately disclosing the position and of the requirements for adequate disclosure.

(2) Advising clients on potential penalties. A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (a)(2) applies even if the practitioner is not subject to a penalty with respect to the position.

(3) Relying on information furnished by clients. A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, generally may rely in good faith without verification upon information furnished by the client. However, the practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent, or incomplete.

(4) Definitions. For purposes of this section:

(i) Realistic possibility. A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a position will not be challenged by the Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) may not be taken into account.

(ii) Frivolous. A position is frivolous if it is patently improper.

(b) Standard of discipline. As provided in §10.52, only violations of this section that are willful, reckless, or a result of gross incompetence will subject a practitioner to suspension or disbarment from practice before the Service.

[1]Repealed in 1989 by P.L. 101-239, Sec. 7721(a).

valuation) will cause a warning to be issued or not permit printing the return.

[B] Special use valuation elected?

The requirements for special use valuation are discussed in "Chapter 5. Schedule A-1, Section 2032A Valuation" and a "yes" answer here requires completing Schedule A-1. Some preparation software will not let the preparer enter data for Schedule A-1 unless this is checked "yes." Also, some software contains failsafes where a "yes" answer when the return does not qualify for special use valuation will cause a warning to be issued or not permit printing the return.

[C] Section 6166 installments elected?

If elected the required information must be included. IRC § 6166 installments are discussed above.

[D] Section 6163 remainder taxes postponed?

The requirements for this are set forth in the regulations. This may have little practical value to the estate because the IRS can require the posting of a bond or security equal to the tax.

§3.08 *Part 4. General information*

[A] Authorization

This is discussed in "Power of Attorney" in "Chapter 1, General Matters." Usually when preparing the return your author will complete this so the first inquiry from the IRS comes to the preparer.

[B] Death certificate

As stated above, a certified copy of the death certificate must be attached.

Death certificates issued in Texas contain the warning, "IT IS ILLEGAL TO DUPLICATE THIS COPY." When making a copy for the state, clients, the firm, etc. stamp the copy, preferably in red or blue ink, "COPY."

[C] Decedent's business or occupation

In reviewing the return, the IRS will make sure the assets on the return are consistent with the decedent's occupation. The possibilities are endless: a performing artist should have intellectual property rights, a business person should have stocks or business interests, a rancher should have land, ranch equipment and livestock, etc.

[D] Marital status

If the decedent was a widow or a widower, the preparer of the return should review any Form 706 for the predeceased spouse. Upon audit, the Estate Tax Attorney may attempt to trace assets from one estate to the other.

[E] Beneficiaries

> To give away money…is an easy matter and in anyman's power, but to decide to whom to give it and how large and when, and for what purpose and how, is neither in every man's power nor an easy matter. Hence, it is that such excellence is rare, praiseworthy, and noble.
>
> Aristotle

This section may appear to be of little importance to the IRS. Actually it may be of great interest. Certainly, to beneficiaries, it is of great importance. Estimates are authorized and beneficiaries receiving less than $5,000 each can be lumped together. But, the amounts flowing to each beneficiary must result from the decedent's estate plan, as represented by decedent's will, trust and non-testamentary transfers. The estate tax or the GST tax properly due will depend upon whom the proper recipient of the property is:

i. the spouse, where a marital deduction can be taken;
ii. a charitable organization, where a charitable deduction can be taken; or
iii. a skip person, subject to GST tax.

The proper beneficiaries and the amounts calculated to be received by each can result in litigation where the IRS sees an opportunity for additional tax, such as what occurred in *Estate of McDonald v. U.S.*, No. 02AR1765-5 (U.S.D.C. N.Alabama, 2003). Decedent's will directed forgiveness of any debt owed decedent by any "child of mine." The estate claimed this provision required payment to decedent's son for debt acquired by decedent under a power of attorney during incompetency and not go to a trust that would incur a GST tax. The estate also claimed a charitable deduction for an amount calculated before payment of estate taxes, increasing the amount of the deduction and decreasing the taxes. Upon challenge by the IRS the court determined that under Alabama law, the purported attorney-in-fact had authority to acquire the debt owed by decedent's son and thus its forgiveness did not result in GST tax and the assets passing to the charitable beneficiary were not subject to estate taxes. The amount of taxes due under the IRS claim, $504,723, made it worthwhile for the IRS to pursue these issues, although it did so unsuccessfully.

The lack of an identifiable beneficiary does not change the taxable nature of the estate. "Escheat of a decedent's property to the state for lack of heirs is a transfer which causes the property to be included in the decedent's gross estate." Treas. Reg. §20.0-2(a).

There should be no penalty for listing the taxpayer ID number as "unknown." The Instructions, p. 2, state, "If the number is unknown, or if the

individual has no number, please indicate 'unknown' or 'none.'"

Also, a gift under the estate plan to one beneficiary may require a taxable gift for the property to ultimately go to another beneficiary. This makes a good place to discuss disclaimers.

§3.09 *Disclaimers*

[A] What are disclaimers?

A disclaimer is a refusal to accept a bequest or gift. When administering an estate and preparing an estate tax return, it can be used to revise the decedent's dispositive plan to accomplish tax or non-tax results. To accomplish the tax results, the disclaimer must be a "qualified disclaimer" that meets the requirements of IRC § 2518 and Treas. Reg. §25.2518-1 through §25.2518-3.

If a qualified disclaimer is made for the federal estate, gift and generation-skipping transfer tax provisions are to apply with respect to the property interest disclaimed as if the disclaiming person (sometimes called the "disclaimant") had predeceased the donor-decedent or died before the date on the transfer creating the interest was made. With a "qualified disclaimer" the disclaimed property is treated as if it was never transferred to the disclaimant, and the disclaimant is not treated as having made a gift to the person to whom the interest passes by reason of the disclaimer. The consequences of a disclaimer with regard to the decedent's estate tax return are discussed in the discussion of the schedules.

[B] Qualified disclaimer requirements

To be a "qualified disclaimer," the disclaimer must meet the requirements of both IRC § 2518(a) and Tex. Prob. Code Section 37A. Briefly, the disclaimer must be:

- in writing;
- irrevocable;
- signed before a notary public;
- filed with the probate court;
- copies of memorandum of disclaimer delivered or mailed and received by the personal representative; and
- completed not later than nine months after the date of death.

The latter requirement presents the most difficulty because under the federal rules, there are no extensions and under state law there may be no holiday or weekend rules. The six month extension to file Form 706 has no counterpart in either Texas disclaimer law or Federal disclaimer law. Texas disclaimer law has no holiday rule, meaning that if the date nine months after the date of death is on a Monday that is a legal holiday, or on a Saturday or Sunday, then the disclaimer must be filed at the courthouse by the close of business the previous business day. Further, the requirement that it be received by the personal representative before nine months have run, creates a tremendous problem if the personal representative is out of the county or unavailable when the nine month date is expiring.

[C] Non-acceptance of property

To be a qualified disclaimer, the disclaimant must not have accepted the property or any of its benefits. When a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by the disclaimant in the exercise of fiduciary powers to preserve or maintain the disclaimed property are not treated as an acceptance of the property or its benefits, but a disclaimant cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed property.

When a disclaiming beneficiary is a cotenant with the decedent in real property to be disclaimed, examine applicable state law to determine whether the beneficiary's occupancy of the whole or collection of rents amounts to acceptance. Under state law the cotenant may have rights to occupy the whole or to collect rent for the whole and such acts may in and of themselves not amount to acceptance of the decedent's co-tenancy.

Some creative legal thinking may avoid the full reach of the acceptance of benefits prohibition, as in PLR 200503024 where a disclaimer was allowed even though the surviving spouse exercised considerable control over a joint brokerage account. Upon the death of her husband the wife became entitled to an account by survivorship and she directed the broker to transfer title to her name and to sell a portion of the securities. She withdrew a portion of the cash. Legal counsel advised her to disclaim the brokerage account so it could pass into a credit shelter trust and she disclaimed her beneficial survivorship interest in her husband's share of the account less the assets in that share in which the wife accepted benefits. The broker was directed to establish separate accounts for what was the wife's contributions plus what she sold from the husband's assets and what was the husband's assets that she did not sell. The IRS ruled that changing the title on the account into the wife's name did not amount to acceptance of the husband's benefits and dividing the account into separate accounts also did not involve accepting all of the husband's account. Selling some of the assets and withdrawing the cash were severable from the other assets in the husband's account.

[D] Non-qualified disclaimers

A disclaimer that is not a qualified disclaimer will be disregarded for federal tax purposes and the

disclaimant will be treated as having received the interest and potentially as having made a gift to the ultimate recipient. Treas. Reg. §25.2518-1(b).

[E] What can be disclaimed by whom?

Under Tex. Prob. Code §37A "property" may be disclaimed by any "beneficiary."

> "property"...shall include all legal and equitable interests, powers, and property, whether present or future, whether vested or contingent, and whether beneficial or burdensome, in whole or in part.

In defining "beneficiary," the statute lists some of the types of property within the property definition.

> "[B]eneficiary" includes a person who would have been entitled, if the person had not made a disclaimer, to receive property as a result of the death of another person by inheritance, under a will, by an agreement between spouses for community property with a right of survivorship, by a joint tenancy with a right of survivorship, or by any other survivorship agreement, account, or interest in which the interest of the decedent passes to a survivorship beneficiary, by an insurance, annuity, endowment, employment, defined compensation, or other contract or arrangement or under a pension, profit sharing, thrift, stock bonus, life insurance, survivor income, incentive, or other plan or program providing retirement, welfare, or fringe benefits with respect to an employee or a self-employed individual.

This language permits disclaimer of property as that term is commonly understood but also the benefits of an expense or tax allocation clause or provision.

[F] Preparing disclaimers

Disclaimers are legal documents that must be prepared with the utmost care to make certain that the disclaimed property passes to the intended person. The disclaimer draftsperson should have the draft disclaimer reviewed by an experienced, knowledgeable practitioner to make sure the disclaimer plan works. The wise preparer drafts disclaimer documents with caution.

§3.10 *Required questions*

Answers to the Part 4 questions will determine if certain schedules must be filed.

[A] Section 2044 property

Question 6. "Does the gross estate contain any Section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate)?" Section 2044 property is included in the decedent's estate because of a QTIP gift by the decedent's previously deceased spouse, either *inter vivos* or testamentary, or *inter vivos* by the decedent's surviving spouse.

[B] Gift tax returns

Question 7. "Have Federal gift tax returns ever been filed?" If answered "yes," the periods covered are to be listed and the IRS office where filed stated and copies of each return is to be attached.

[1] Attached to estate tax return

The executor must obtain all of the decedent's gift tax returns for gifts made since June 6, 1932, when the present federal gift tax became permanent. IRC § 6103(e)(3) permits inspection of a decedent's return by his fiduciary and certain family members. Copies should be attached to the estate tax return as supplemental documents. The gift tax returns are required to calculate the estate tax. Instructions, p. 4.

[2] Unreported gifts

In calculating the estate tax, the executor must include any gifts in excess of the annual exclusion made by the decedent, on or behalf of the decedent under a power of attorney, but for which no Forms 709 were filed. The executor must make a reasonable inquiry as to such gifts, Instructions, p.4, and the preparer should inform the executor of this responsibility. The instructions do not set forth the proper wy to report such gifts. One way to report such gifts would be for the executor to file gift tax returns for the decedent separate from the Form 706, but attach copies of the gift tax returns to the Form 706 along with any proof of filing. Another way would be to simply add the amount of such gifts to adjusted taxable gifts, attach a statement of explanation, but not file gift tax returns.

In *Estate of Rebecca Wineman v. Comm.*, TC Memo 2000-193, the tax court held that decedent's rental of her interest in ranch land at below-market value rates to a closely held corporation owned by her children constituted taxable gifts to her children under IRC § 2053, and included as adjusted taxable gifts for purposes of calculating the estate tax.

[3] Gift splitting

The executor may consent to gift splitting with the decedent's unremarried spouse, of any gifts either of them made to third parties. Treas. Reg. § 25.2513-2(c).

[4] Locating gift tax returns

An executor may be subject to a negligence penalty if the decedent filed gift tax returns but none were reported on the Form 706. The executor should make a documented reasonable inquiry to defend against imposition of a negligence penalty if gift tax returns turn up after the Form 706 is filed.

A copy of a gift tax return filed by the decedent if properly completed, will list all gift tax returns previously filed by the decedent. The executor should be able to rely on that list, and the executor's

inquiry should be limited to any periods between the period covered by the last gift tax return and the date of death, unless in the absence of inquiry the executor has knowledge of unreported gifts.

If the executor relies in good faith on the decedent's gift tax returns furnished by the IRS to determine either adjusted taxable gifts or the existence of prior gifts for which returns were filed, and then ultimately whether an estate tax return may be due in a borderline situation, the executor will be discharged from personal liability for any estate tax deficiency attributable to adjusted taxable gifts made more than three years before the date of death, even though they are not shown on those returns. IRC § 2204(d).

If uncertain regarding gift tax returns filed by the decedent, the executor can request a transcript from the Taxpayer Service Office by writing to the Disclosure Officer and enclosing letters testamentary. The IRS will provide a transcript with year-by-year summary of the decedent's gift tax account, showing the amount of adjusted taxable gifts and any gift tax paid.

To obtain prior gift tax returns, the executor can submit Form 4506 to the various Service Centers in which the gift tax returns would have been properly filed.

[5] Revaluation

Gifts made by the decedent may be revalued for estate tax purposes, unless the gift tax returns make full and adequate disclosures of the gifts. IRC § 2001(f). This applies only to gifts made after the date of enactment of the Taxpayer Relief Act of 1997, August 5, 1997, and gifts made prior to that date may be made prior to that date.

[C] Insurance on decedent's life

Question 8a. "Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?" If answered "yes," the insurance must be reported on Schedule D along with an explanation of why the policy or its proceeds are not includable in the gross estate. Instructions, p. 11.

[D] Insurance on life of another

Question 8b. "Did the decedent own any insurance on the life of another that is not included in the gross estate?" The Instructions states that if answered "yes," you must attach Schedule D and give an explanation of why the policy or its proceeds are not includable in the gross estate. *Id*. This is a curious instruction because insurance on the life of another is reported on Schedule F. Apparently, the question is not limited to ownership at the time of death but could be at anytime prior to death, unless this question is designed to ferret out instances in which a decedent owns a policy on another's life and the preparer and executor mistakenly believe the policy is not included in the gross estate.

[E] Jointly owned property

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?" If "yes," the Form, p. 3, states that Schedule E must be completed and attached. Actually, Schedule E must be attached if (a) is correct, regardless of (b).

[F] Partnerships, unincorporated businesses, closely held corporations

Question 10. "Did the decedent, at the time of death, own any interest in a partnership or unincorporated business or any stock in an inactive or closely held corporation?" A "yes," because of partnerships and unincorporated businesses, requires full details on Schedule F, unless it is a survivorship interest to be reported on Schedule E. A "yes," because of stock in an inactive or closely held corporation, requires full details on Schedule B, again unless it is a survivorship interest to be reported on Schedule E.

[G] Transfers during life

Question 11. "Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G...)?" A "yes" requires completing and attaching Schedule G.

[H] Trusts created by or for decedent

Question 12. This is two questions, each requiring its own answer.

> "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. Any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?"

A "yes" to 12a requires completing Schedule G and a "yes" to 12b requires completing Schedule F, and a copy of the trust instrument is to be attached to the relevant schedules.

[I] Powers of appointment

Question 13. "Did the decedent ever possess, exercise, or release any general power of appointment?" A "yes" answer requires completing and attaching Schedule H.

[J] Marital deduction under ERTA

Question 14. "Was the marital deduction computed under the transitional rule of Public Law

97-34, section 403(e)(3) (Economic Recovery Tax Act of 1981)?" A "yes" answer requires computing the marital deduction under the rules that were in effect before the Economic Recovery Tax Act of 1981. Your yes answer serves as a signal to the IRS that the unlimited marital deduction is not permitted because there was a will or trust executed prior to September 13, 1981, where there is a martial deduction formula clause that says that the surviving spouse receives the maximum marital deduction and the will or trust formula was not amended after September 13, 1981, to refer specifically to an unlimited marital deduction, and there is no state statute saying that the will is to be read as giving a maximum marital deduction gift. Before answering "yes," make sure that you are dealing with a formula clause that is a maximum marital deduction clause because, if open to interpretation but the preparer believes that under the standards applicable to preparers, there is sufficient reason to believe the formula clause is not a maximum marital deduction, it would be better to file the return without a yes answer and avoid undue review of the issue. Preparers will be seeing fewer and fewer of these because most decedents will have wills executed after September 13, 1981.

Table 10
Comprehensive Outline (2005)

Gross estate (§§2031-2045)		$xxx,xxx
Less deductions:		
Debts & expenses (§2053)	xx,xxx	
Losses during administration (§2054)	xx,xxx	
Charitable bequests (§2055)	xx,xxx	
Marital bequests (§§2056-2056A)	xx,xxx	
State death taxes (§2057)	xx,xxx	xxx,xxx
Leaves: Taxable estate (§2051)		xxx,xxx
Plus: Adjusted taxable gifts (post-76) (§2001)		xx,xxx
Equals: Estate tax base (§2001(b)(1)(A)&(B))		$xxx,xxx
Calculate: Tentative tax (§2001)		$xxx,xxx
Less Credits:		
Gift taxes payable (post-76) (§2001(b)(2))	xx,xxx	
Unified credit (§2010)	xx,xxx	
Prior transfer credit (§2013)	xx,xxx	
Other credits (§§2014-2015)	xx,xxx	
		(xxx,xxx)
Equals: Federal estate tax (§2001)		$xxx,xxx

Adapted from Bost, Estate Planning and Taxation, 2000 Annual Ed., at 222.

[K] Annuities

Question 15. "Was the decedent, immediately before death, receiving an annuity described in the 'General' paragraph of the instructions for Schedule I?" A "yes" requires completing and attaching Schedule I.

[L] QTIP property

Question 16. This question is designed to help the IRS avoid being whip-sawed. "Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) [QTIP] and which is not reported on this return?" A "yes" requires attaching an explanation.

§3.11 *Federal estate tax (Form 706) comprehensive outline*

Table 10, Comprehensive Outline, gives a mathematical outline of how the federal estate tax is calculated for estates of decedents dying in 2005.

> "The return of an estate of a decedent who was a citizen or resident of the United States at the time of his death must contain an itemized inventory by schedule of the property constituting the gross estate and lists of the deductions under the proper schedules. The return shall set forth (1) the value of the gross estate (see §§ 20.2031-1 through 20.2044-1), (2) the deductions claimed (see §§ 20.2052-1 through 20.2056 (e)-3), (3) the taxable estate (see § 20.2051-1), and (4) the gross estate tax, reduced by any credits (see §§ 20.2011-1 through 20.2014-6) against the tax."
>
> Treas. Reg. §20. 6018-3.

Appendix A gives a sample explanation for the client to accompany a draft of the return. This may, as of June 20, 2005, be subject to Circular 230.

§3.12 *Table of contents*

Because of the substantial number of documents required to be attached to the return, location of documents and ease of reading the return is aided by a table of contents. Attached as Appendix E is a sample of a table of contents for a Form 706, schedules and required attachments. Make a copy of Appendix E and use it as a checklist for preparing your return.

[A] Supplemental documents required by schedules

Other supplemental documents that are required are discussed with the various schedules.

> The description of property (other than household goods and personal effects) on the schedules must be such that the property may be readily identified for the purpose of verifying the value placed on it by the executor.
>
> Treas. Reg. §20.6018-3(a).

[B] Permissive supplemental documents

The regulations permit filing copies of any documents that the executor may desire to submit in explanation of the return. Treas. Reg. §20.6018-4(a).

§3.13 *Schedules required*

[A] Asset schedules

Generally, if a zero is filed on the recapitulation, that schedule need not be filed. However, Schedule F must be filed for every estate. Instructions p. 3. While not stated in the general instructions, as explained below, it is possible that a schedule with a zero value must still be filed.

The description of property (other than household goods and personal effects) on the schedules must be such that the property may be readily identified for the purpose of verifying the value placed on it by the executor. Treas. Reg. §20.6018-3(a).

[B] Deduction schedules

If a deduction is claimed, that schedule must be filed.

[C] Generation-skipping

Schedule R must be filed to allocate exemption even if no GST tax is reported.

§3.14 *Assembling for filing*

The Instructions provide a checklist, the 2004 version of which is included below, of items to make sure are included in the filed return. Some of these items are performed automatically by Form 706 preparation software.

Checklist 3
Checklist for Completing Form 706

To ensure a complete return, review the following checklist before filing Form 706.

Attachments . . .
? Death certificate – you must attach.
? Certified copy of the will – if decedent died testate, you must attach. If not certified, explain why.
? Appraisals – attach any appraisals used to value property included on the return.
? Copies of all trust documents where the decedent was a grantor or a beneficiary.
? Form 4768, if you received an extension
? Form 2848 or 8821, if applicable.
? Copy of any Form(s) 709 filed by the decedent.
? Form 712 if filing Schedule D.
? Form 706-CE if claiming a foreign death tax credit.
? Explanation of reasonable cause for late filing, if applicable.

Have you . . .
? Signed the return at the bottom of page 1?
? Had the preparer sign, if applicable?
? Obtained the signature of your authorized representative on Part 4, Page 2?
? Reduced the state death tax credit to 25% as shown on line 13, page 1?
? Entered a Total on all schedules filed?
? Made an entry on every line of the Recapitulation, even if it is a zero?
? Included the CUSIP number for all stocks and bonds and the EIN of closely held entitles?
? Included the first 3 pages of the return and all required schedules?
? Completed Schedule F? It must be filed with all returns.
? Completed line 4, Part 4, page 2, if there is a surviving spouse?
? Completed and attached Schedule D to report insurance on the life of the decedent, even if its value is not included in the estate?
? Included any QTIP property received from a pre-deceased spouse?
? Entered the decedent's name, SSN, and "Form 706" on your check or money order?

4 SCHEDULE A - REAL ESTATE

§4.01 *When completed*

Schedule A is completed when real estate is included in the estate or the decedent has contracted to purchase real property, with certain exceptions listed and discussed below. The executor should locate and the preparer should review all deeds to the decedent's real estate to determine the exact interest that the decedent owned, not only to be certain that the real estate is listed on the proper schedule, but also to ensure that the return does not list real estate interests not owned by the decedent.

Return of the property on Schedule A may be a strong indication that the property is real property subject to probate in the state in which the real property is located and subject to estate taxes in the state in which located even if not the decedent's domiciliary estate. Returning the property on another schedule may not necessarily be an indication that the property is not subject to probate in the state in which the real property is located nor is it an absolute indication that the property is subject to estate taxes only in the state of the decedent's domicile.

[A] 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, Form, Schedule E, p. 18, and Form, Schedule A, p. 4.

[B] 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. Form, Schedule F, p. 20, and Form, Schedule A, p. 4.

[C] Reversionary interests and remainders

These are properly reported on Schedule F. The same is true for a life estate created by another.

[D] Real estate included in gross estate not titled in decedent

Real estate included in the gross estate under IRC §s 2035, 2036, 2037, or 2038 are properly reported on Schedule G. Form, Schedule A, p.4.

[E] Real estate subject to power of appointment

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

[F] Leaseholds

Leaseholds are properly reported on Form, Schedule F p. 20.

[G] Real estate decedent contracted to sell

Real estate that the decedent contracted to sell is properly listed on Form, Schedule C p. 14. If the contract did not have specific performance and the buyer could walk away without penalty, consider negotiating a new contract for sale by the estate, in order to get the step-up in basis and avoid capital gain; list such property on Schedule A.

[H] 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. Form, Schedule F, p. 20.

[I] Cooperative apartment

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

[J] Special use value

Real property for which special use IRC § 2032-A valuation is elected is reported both on Schedule A and Schedule A-1. Form, Schedule A, p. 4.

§4.02 *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).

§4.03 *Outside U.S.*

The Instructions, p. 1, state that the gross estate includes real property outside the U.S. The proper schedule on which such real property is reported is not affected because the property was outside the U.S.

§4.04 *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.

The regulations state that a legal description shall be given of each parcel of real estate. Treas. Reg. §20.6018-3(a).

> A legal description shall be given of each parcel of real estate, and, if located in a city, the name of the street and number, its area, and, if

improved, a short statement of the character of the improvements. *Id*.

Consider reporting a description that corresponds with the disposition under a will or trust. For example, under Texas law, a devise in a will of "my 40 acres in Edwards County" or of "my real property in Edwards County" are sufficient to transfer decedent's real property in Edwards County, Texas. The description on the return may be best reported as "Decedent's 40 acres in Edwards County, Texas."

Your author has been requested upon audit to provide a city map identifying undeveloped real property so it can be inspected by the auditor.

§4.05 *Valuation*

Fair market value is determined by the real property's highest and best use. Actual use for farm and closely held business real property cannot be used unless IRC § 2032A can be elected.

[A] How determined

The instructions and regulations do not require that an appraisal be submitted. On value, the instructions simply state, "Explain how the reported values were determined and attach copies of any appraisals." Form, p. 5

[B] 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.

[1] Property tax assessment

In Texas, real estate is to be assessed property tax at100% of its value. Residences may be valued for tax purposes near their fair market value, but the tax value may vary substantially from fair market value for other properties, especially farm and ranch land, which for property tax purposes, may be appraised at open space value.

[2] Upon audit

The examining attorney is to check the property tax valuation, which is of public record, before consulting the estate representative. Examiner's Handbook, §630. Is a failure to protest the property tax value, when it is substantially more than the returned value, an admission against interest by the decedent? Be prepared to explain the difference in event of an audit.

[C] Appraisal

Even though not required, 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.

[1] Appraiser engagement letters

See the subsection entitled "Appraiser engagement letters" in Chapter 6 on for a discussion on the importance of the engagement letter and the "Appraiser Engagement Letter Checklist."

[2] Appraisal process

Consider requesting that no appraisal report be prepared until the appraiser first reports to the return preparer the value. If the oral value substantially varies from the expected value, pay for the appraisal work performed to date and request that no further work be performed and no report be prepared. No report needs to be produced to the IRS upon its request during audit for all written appraisals.

[3] 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. Checklist 3, Real Estate Appraisal Review Checklist, lists the items to look for when making your review.

[4] Appraisal methods

Appraisals use one or more of three valuation methods:

1. Comparable sales. The most common method used; the subject real property value is found by analyzing actual selling prices near the valuation date for properties with reasonably similar characteristics.
2. Replacement cost. Value is found by estimating what it would cost to rebuild structures on the decedent's land at current construction prices with appropriate decreases for depreciation.
3. Capitalization of the income. Used for income producing properties; the future income stream is discounted to its current value.

The *IRS Valuation Training for Appeals Officers Coursebook, 4-2,* states:

> A discounted cash flow analysis can produce almost any result an appraiser wants with slight changes to the holding period, the annual cash flows, and the estimated reversion. Unless the person using this method has a crystal ball, its use should be viewed with skepticism.

[5] Negative factors upon appraised value

An appraisal may not consider factors that can have a substantial negative affect upon value, such as problems with the legal description or title and environmental problems. Here are two statements of limiting conditions taken from an actual appraisal report.

> The legal description furnished is assumed to be correct. The firm assumes no responsibility

for matters legal in character, nor renders any opinion as to the title, which is assumed to be good. The property is evaluated as if vacant and no responsibility is taken for unknown or hidden property adversities.

Unless otherwise stated in this appraisal, the existence of hazardous material, which may or may not be present on the property, was not observed by the appraisers. The appraisers have no knowledge of the existence of such materials on or in the property. The appraisers, however, are not qualified to detect such substances. The presence of substances such as radon, asbestos, urea-formaldehyde foam insulation, or other potentially hazardous materials may affect the value of the property. The value estimate reported herein is predicated upon the assumption that there is no such material on or in the property that would cause a loss in value. No responsibility is assumed for any such conditions, or for any expertise or engineering knowledge required to discover them. This client is urged to retain an expert in this field, if desired.

An estate will not "trash" a property (create a title problem or environmental contamination) to get a lower value, but if a title problem or environmental contamination exists, the value should not be overstated by ignoring existing problems.

With regard to real property with environmental contamination, at first blush it would appear that th aerere two approaches to appraisal: market comparables of similarly contaminated real property and market comparables of uncontaminated property less the cost of environmental remediation. The first approach is particularly difficult because of the lack of comparables on contaminated properties being sold and, even if available, the lack of similar contaminations. The best approach may be market comparables of similar real property less the cost of remediation and possibly also less a discount due to market uncertainty caused by the fact of the environmental contamination. Deduction of the estimated costs of remediation from the uncontaminated fair market value of the real property was approved in *Est. of Necastro*, TCM 1994-352.

Checklist 4

Real Estate Appraisal Review Checklist

- ❑ Is the correct definition of fair market value set forth?
- ❑ Is the reason for the appraisal set forth?
- ❑ 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?
- ❑ Is highest and best use stated?
- ❑ 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?
- ❑ Are comparables close in time to the valuation date?
- ❑ Is the zoning the same?
- ❑ For a residence, is the school district the same?
- ❑ Are square footages or acreage similar?
- ❑ Are utilities, street access, flood plain and topography considered?
- ❑ 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 environmental issues properly considered?
- ❑ Is the math correct?
- ❑ 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 appraiser's 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)?
- ❑ Are the appraiser's qualifications stated?

[D] Improvements versus removeable trade fixtures

An important valuation issue can arise as to whether equipment on the real property are improvements to be valued as part of the real property to be appraised, or removable trade fixtures not part of the real property and not included in the decedent's estate. In *J. Frazier Estate*, ¶45, 167 TC Memo (2002), the tax court held that the decedent's gross estate included most of the improvements

made to his real property by his family-owned corporation that was leasing the property at the time of his death because, under California law, the improvements were not removable trade fixtures. The decedent leased a five acre tract of land for an initial ten year term to his family-owned corporation, which processed and sold almonds and walnuts and made eleven significant improvements to the leased property. The improvements remained on the property after the lease expired and the decedent died three months later. The tax court initially held that the value of all the improvements were includable in the decedent's gross estate because the ownership of the improvements passed to the decedent upon termination of the lease. The Ninth Circuit reversed ruling that the lease included an implied right to remove trade fixtures, even after the decedent's death. The Circuit Court remanded the case for determination of whether the improvements were trade fixtures under California law. On remand, the tax court determined that most of the improvements were not removable trade fixtures and they were, therefore, includable in the decedent's estate, but two of the improvements were removable trade fixtures because they were never intended to become an integral part of the premises and were easily removable and thus were not includable in the decedent's estate.

[E] Rental property

[1] 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 on Schedule A as they represent income in respect of a decedent.

[2] Depreciation

Depreciation for income tax purposes after the date of death will be computed based upon the new basis the rental property received upon decedent's death.

[F] Discounts

See previous discussion of lack of marketability discounts for fractional interests in real property. In a taxable estate, the preferable practice is to have the appraiser document the appropriate discount, rather than taking an arbitrary figure. The latter practice is commonly seen where community property or co-tenancy property is included in a non-taxable estate.

[1] Market absorption discount

This discount may be appropriate where the estate holds a large number of a particular type of assets, such as subdivision lots, which would depress the market if disposed of within a short period of time. *IRS Valuation Training for Appeals Officers Coursebook*, 4-27.

[2] Environmental contamination

This is discussed above in the section "Negative factors upon appraised value."

[3] Catastrophic events discounts

If the decedent died on September 11, 2001, or soon thereafter is the estate entitled to a catastrophic events discount? Based upon comparable sales up to September 11, a given value would be indicated, but there would be a temporary decline in the market on the date of death due to the 9-11 events. If the willing seller would not have sold over a period of days or weeks, but instead would have waited, the sales prices would be based on the overall trend in the market. One would expect the willing buyer to demand a substantial discount for an earnest money contract on September 12. One might argue that this is not unlike the blockage discount for publicly traded stock where the discount is determined assuming that a sale over a reasonable period of time would be required. By analogy had the stock market been open on September 12 one could have seen a drop even greater than the drop which occurred when it opened nearly a week later.

There are several problems with this discount as it applies to real estate. It tends to focus too much on the willing buyer's expectations and too little on the willing seller. You probably would not have a willing seller on the date of death that would sell with steep discounts, but you may have a willing seller who is willing to sell at a small discount. Also, valuation of real estate assumes a reasonable amount of time to market the property, whereas a substantial and arbitrary discount for a catastrophic event that depresses the market for several days seems to reach a value based upon a forced sale. Another problem is how one quantifies the discount. The real estate market is not regarded as being as volatile as say the stock market, and daily fluctuations are hard to detect and even harder to quantify. Comparisons to the stock market may be misplaced; rather the comparison should be to the valuation of closely held business interests where again a reasonable time to market the property is assumed in the valuation. Moreover, there are no cases in which a catastrophic event discount has been taken, and alternate valuation is designed to account for catastrophic losses with long term effects, albeit inadequately at times.

It seems that any approach must try to obtain prices for earnest money contracts on the valuation date and not solely rely on closings for contracts entered into before the valuation date. Real estate appraisers tend to rely exclusively on closings at or near the valuation date, whereas when there is a sudden movement in real estate prices, the reliance should be on earnest money contracts at or near the

valuation date. Also, any drop between pre 9-11 sales and post 9-11 sales will not be gradual, bur rather will be a sudden drop immediately upon occurrence of the event. In conclusion, if you cannot obtain data, take an arbitrary discount, but make every effort to quantify your value by focusing on post event earnest money contracts.

Also, see the discussion on catastrophic economic events at the subsection "Catastrophic events discounts," in Chapter 5, entitled "Schedule B, Stocks and Bonds," and the subsection "Economic losses," in Chapter 16, entitled "Schedule L, Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims."

[G] Minerals and unpaid production

[1] Mineral interests

Mineral interests that are real property interests according to the law of the state where located should properly be listed on Schedule A. Mineral interests that are not real property should be listed on Form, Schedule F, p. 20. A separate item for the minerals of each state will facilitate completing the various state returns.

[2] Valuation

There are several ways to value mineral properties, most similar to other real property, with a multiple of earnings being somewhat unique.

[a] Appraisal

There is no recognized certifying organization for mineral appraisers. Anyone who holds himself or herself out as a mineral appraiser is "qualified," and there are excellent appraisers available. Appraisal is usually limited to substantial mineral holdings to make the appraisal expense cost effective. Beware of appraisals on non-producing minerals, because non-producing minerals can have a nominal value under the multiple of earnings method. Non producing minerals have at most a speculative value, which is next thing to no value for estate tax purposes.

Appraisals may be based upon an estimate of reserves or a decline curve of past production used as an indicator of future production.

[b] Sales value

If the minerals are sold subsequent to death in an arm's length transaction, then that is probably the best indication of value. Mineral properties usually bring little more than 1.5 to 2 times earnings, so time sales to use this value on the return.

[c] Comparable sales

You might be able to find comparable sales for the minerals, but there are many types of mineral properties, even oil and gas, so be careful if inexperienced.

[d] Multiple of earnings

Anyone can do this appraisal. Average annual production for the last 2 to 5 years is usually multiplied by 2. Ask a person who buys minerals what multiple of production they are using and you might get a lower multiple. The IRS usually accepts this method when the resulting value is under half a million and may accept it for even greater value of minerals. Oklahoma requires an appraisal or use of a multiple of 4.

[3] Unpaid production

Unpaid production should be listed on Schedule A and it represents income in respect of a decedent. Unpaid production is an intangible that should be taxed in the state of the decedent's domicile, not necessarily in the state in which the minerals are located. Minerals that have been extracted from the ground but not yet paid to the decedent are considered unpaid production and it is an IRD item.

[H] Timeshares

Timeshares are the right to use a particular unit of a real estate development for a particular time of the year, usually defined as a particular week of the year. They are vacation properties rather than primary residences. Timeshares may be traded for different units, different periods of time or different developments, such as a development in a different city or resort. Depending upon the state or the development, the timeshare may be real estate, properly reported on Schedule A, or personal property, properly reported on another schedule. Timeshares are many times valued through offering prices, which tends to overstate the values, because such prices may not be realized or if realized only after an unusually long offering period that properly should be taken into account to decrease the offering price to arrive at fair market value. Timeshare values from brokers should be taken with a grain of salt and possibly a downward adjustment.

§4.06 *Partial interests*

If decedent owned less than the entire interest, then only the interest owned should be reported, but the partial interest must be owned by another at the time of death. *Scott v. Comm.*, 226 F.3d 871, 875 (7th Cir. 2000), involved a decedent in a same-sex relationship who purchased a house and held title only in her name. After decedent's death, her partner filed a claim in probate court seeking a 50 percent tenancy-in-common interest in the home under a resulting trust theory and received the requested order. Decedent's partner, as executor, reported 50% of the value of the home on the estate tax return. The tax court held that the partner had not proved that a resulting trust existed at the time of the decedent's death.

§4.07 *Mortgages*

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

[A] 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 Form, Schedule K, p.5. Here the amount of the unpaid mortgage can exceed the value of the real property with a net decrease to the estate. Treas. Reg. §20.2053-7.

[B] 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. Treas. Reg. §20.2053-7.

[C] Mortgages and non-residents

Estate of Hon Hing Fung, 117 TC No. 21 (2001) applied the rule regarding personal liability in the estate of a non-resident alien to the tax detriment of the decedent's estate. Because the decedent was personally liable, the full value of the mortgaged property was reported on Schedule A and the amount of the mortgage was listed on Schedule K, but IRC § 2106(a)(1) provides for allowance of that proportion of IRC § 2053 deductions that the decedent's gross estate situated in the U.S. bears to the value of the entire gross estate wherever situated. Thus, the amount of the mortgage that could be deducted was reduced. Had the decedent not been personally liable, the full amount of the mortgage would be deducted from the property and the net listed on Schedule A. Affirmed by the Ninth Circuit in an unpublished memorandum opinion, *H. Fung Est*., CA-9, 2003-1 USTC ¶60,460.

§4.08 *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 Form, Schedule K, p. 5.

If the decedent's net worth does not meet the minimum amount to file, a contract to purchase real property may increase the assets above the minimum amount to file.

§4.09 *Special exclusions*

[A] 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. This regulation also appears to apply to crypts and columbarium, which can also be high dollar rights.

With regard to the beneficiary of any plots in the decedent's estate, consider this quirky statute providing for a special form of intestacy.

> (e) Unless a plot owner who has the exclusive right of sepulture in a plot and who is interred in that plot has made specific disposition of the plot by express reference to the plot in the owner's will or written by written declaration filed and recorded in the office of the cemetery organization:
>
> (1) a grave, niche, or crypt in the plot shall be reserved for the surviving spouse of the plot owner, and
>
> (2) the owner's children, in order of need, may be interred in any remaining graves, niches, or crypts of the plot without the consent of a person claiming an interest in the plot
>
> (f) The surviving spouse or a child of an interred plot owner may each waive his right of interment in the plot in favor of a relative of the owner or relative of the owner's spouse. The person in whose favor the waiver is made may be interred in the plot.
>
> (g) The exclusive right of a sepulture in an unused grave, niche, or crypt of a plot in which the plot owner has been interred may be conveyed only by:
>
> (1) specific disposition of the unused grave, niche, or crypt by express reference to it in a will or by written declaration of the plot owner filed and recorded in the office of the cemetery organization; or
>
> (2) the surviving spouse, if any, and the heirs-at-law of the owner.
>
> (h) Unless a deceased plot owner who has the exclusive right of sepulture in a plot and who is not interred in the plot has otherwise made specific disposition of the plot, the exclusive right of sepulture in the plot, except the one grave, niche, or crypt reserved for the surviving spouse, if any, vests on the death of the owner in the owner's heir-at-law and may be conveyed to them.

Excess plots may not pass by the residuary to qualify for a marital or charitable contribution deduction. If the decedent did not have identifiable family to occupy all available plots, do the excess escheat to the state?

Your author understands that New York, New Jersey, and possibly other states have similar special disposition statutes for places of eternal repose. The bylaws of the cemetery association may take precedence under state law to effect whether the owner has the "exclusive right of sepulture."

[B] Native American allotment land

Rev. Rul. 69-164, 1968-1 CB 220, ruled that the gross estate of a Native American does not include the value of the following property held under the General Allotment Act of 1887 where the decedent dies before issuance of a patent in fee simple to the land: trust lands acquired either in the original allotment or by inheritance; original and inherited headrights; mineral headright income derived from royalties held in trust by the U.S. Government; and trust fund cash directly derived from allotted lands. Trust fund cash not directly derived from allotted lands is not exempt from federal estate tax.

§4.10 *Alternate valuation*

[A] Rent

Rent accrued to the date of the decedent's death on leased real property is included in the alternate valuation as well as the DOD value. Treas. Reg. §20.2032-1(d)(2). Rent accrued after the date of death is not included. Form, Schedule C, p. 5. According to the regulations an advance payment of rent for a period after the alternate valuation date which has the effect of reducing the lease obligation is included in the gross estate and valued as of the date of payment. Treas. Reg. §20.2032-1(d)(2).

[B] 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. *Estate of Johnston by Payne v. U.S.*, 779 F.2d 1123, 1126-1128 (5th Cir.1986).

[C] Appraisals

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

[D] Date of sale

When the executor enters into a contract to sell decedent's interest in real estate within the alternate valuation period, the date of the contract is the date of sale for alternate valuation purposes, even though the deed and purchase price are delivered after the alternate valuation period. Deputy Commissioner's Letter, November 11, 1944 (dealing with predecessor provision with one year alternate valuation period).

§4.11 *Attachments*

1. Copies of any appraisals should be attached. Form, Schedule A, 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 purchase or sale, attach closing statement.

§4.12 *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 Realtors' 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).

5 SCHEDULE A-1 --- SECTION 2032A VALUATION

§5.01 *Why Schedule A-1?*

[A] Description and purpose

Schedule A-1 implements IRC § 2032A which provides a method for executors of estates for estate tax purposes to value property used for farming or in a closely held business at its actual use value rather than at the property's highest and best use. This section was enacted by the Tax Reform Act of 1976 and is an attempt by Congress to provide relief to the estates of farmers and owners of closely held businesses by substantially reducing estate taxes and also to encourage the heirs to continue using the property for farm or small business purposes.

[B] Operation of IRC § 2032A in general

IRC § 2032A allows the executor of an estate containing "qualified real property" used for a "qualified use" which passes to a "qualified heir"

and which meets certain percentage tests as a substantial part of the estate to value the property for estate tax purposes at its actual use based on a capitalization of rents method or a five-factor method. To obtain special use valuation, the executor must check "Yes" to line 2 of Part 3, complete Schedule A-1, and file with the estate tax return an agreement signed by each person who has an interest in the property consenting to the special use valuation. Form, p. 9. The criteria necessary to qualify real property are complex and result from an attempt by Congress to limit the benefits of this section to only family owned farms and closely held businesses. It is most important that the executor of the estate meet all of the requirements for making the election and qualifying the property or the IRS will refuse to allow the election and will value the property at its highest and best use. But if all of the requirements under Section 2032A are met, the federal estate tax value of real property may be reduced up to $840,000 (in 2003) and the instructions for Schedule A-1 are contained on the Form.

[C] Applicable only where subject to development?

No. Land may represent a value beyond its agricultural use due to recreational factors or other location factors such as an isolated location where the rich and famous can get away from it all. Further, the desire by other agricultural operators may drive the market price above its agricultural value. The comparative lease method, IRC § 2032A, divides the net (after ad valorem tax) average of cash leases on comparative land for the five years preceding death by the average Farm Credit System rate for real estate loans over the same period of time, eliminating any excess in land price above that derived from the agricultural income from the land.

[D] Dollar limitations

The benefit of using special use rather than highest and best use have a dollar amount limitation, IRC § 2032A(a) (2), which is pegged to inflation, and set forth in Table 11, Special Use Dollar Limitations.

If a decedent died in 2001, the highest and best use of the decedent's ranch is $3 million and the special use value is $1 million, then the reported value can be reduced from $3 million to $2.2 million.

[E] Discounts

A minority interest or lack of marketability discount are permitted for determining the highest and best use value, but not for determining the special use value. *In Estate of Hoover v. Comm.*, 95-2U.S.TC ¶ 60,217 (10th Cir. 1995), the court held

Table 11
Special Use Dollar Limitations

Death in	Limit	Announced in
1998 or before	$750,000	
1999	$760,000	Rev.Proc. 98-61
2000	$770,000	Rev.Proc. 99-42
2001	$800,000	Rev.Proc. 2001-13
2002	$820,000	Rev.Proc. 2001-59
2003	$840,000	Rev.Proc. 2002-70
2004	$850,000	Rev.Proc. 2003-85

that the $750,000 maximum reduction in value of qualified real property must be subtracted from the true fair market value of a minority interest in that property as figured by employing a minority discount factor. In *Estate of Maddox v. Comm.*, 93 TC 228 (1989) the Tax Court held that an estate could not further reduce the reported special use value by applying a minority interest discount to the special use value. These causes were followed in PLR 200448006.

§5.02 *Who can use IRC § 2032A?*

[A] Decedent

In order for IRC § 2032A to apply, the qualified real property must pass from a decedent who is a resident or citizen of the United States to a qualified heir. IRC § 2032A(a)(1). In addition, the deceased owner or member of the deceased owner's family must have materially participated in the operation of the farm or business. Treas. Reg. §20.2032A-3(a). See below.

[B] Qualified heir

The term "qualified heir" is defined as a member of the decedent's family who acquires the real property from the decedent or to whom the property has passed. IRC § 2032A(e)(1). Should a qualified heir transfer the property to another member of the qualified heir's family, that transferee is considered a qualified heir in regard to the property.

[1] Family member

A member of the family is defined with respect to any individual as (i) ancestors of the individual, (ii) the spouse of the individual, (iii) lineal descendants of such individual, (iv) lineal descendants of a parent of such individual, (v) lineal descendants of the spouse of the individual, and (vi) the spouse of the lineal descendant of a parent of such individual, or (vii) the spouse of a lineal descendant of a parent or spouse of such individual. Section 2032A(e)(2).

[2] Adopted children and widowers

A legally adopted child of an individual is treated as the individual's child by blood. Rev. Rul. 81-179, 1981-2 CB 172. For purposes of electing the special use valuation, a widower of a decedent's

lineal descendant is considered to be a qualified heir. Rev. Rul. 81-236, 1981-2 CB 172.

[3] Trusts as qualified heirs

If all of the current beneficiaries of the trust are qualified heirs, then the trust will not be treated as an ineligible heir. What is the result if the trust contains a power of appointment that permits exercise in favor of nonqualified heirs? In *Clinard v. Comm*. 86 TC 1180 (reviewed opinion), the Tax Court held that the mere existence of a power to appoint to nonqualified persons does not cause the trust to be a nonqualified heir and adopted a wait and see approach. If the power holder exercises the appointment in favor of a disqualified person at some later time, then when that appointment matures, the appointment will be treated as a disposition resulting in recapture.

§5.03 *When does section 2032A apply?*

[A] Required election

The election to take advantage of the special use valuation must be made by the executor of the estate by filing the election with the estate tax return. This election is made by filing Schedule A-1. The election will be effective even if the return is filed late so long as this is the first return filed. IRC § 2032A(d)(1), Treas. Reg. §20.2032A-8(a)(3).

[B] Protective election

A protective election may be filed where it is not certain that the property will meet the requirements for special use valuation. This election must be made by filing a notice of a protective election with a timely estate tax return. If it is determined that the property qualifies for special use valuation, the estate must file an additional notice of election within sixty (60) days of that determination. Treas. Reg. §20.2032A-8(b). This is more fully discussed below.

[C] Automatic extension

An automatic extension of twelve months from the due date for making the estate tax election to specially value qualified real property under IRC § 2032A(d)(1) is available, provided that the executor takes corrective action within that twelve month extension period. Treas. Reg. §301.9100-2. The due date for this purpose is the due date of the return or the extended due date of the return if the executor has obtained an extension of time to file the return. This automatic extension is available regardless of whether the executor timely filed the return, provided the Internal Revenue Service has not yet begun an examination of the filed return. The corrective action means filing an original or an amended return and attaching the appropriate form or statement for making the election. The return making the election must provide the following statement at the top of the return, "FILED PURSUANT TO §301.9100-3."

In PLR 200422045 an extension of time to elect valuation under IRC § 2032A was granted. The decedent's estate included stock of a corporation engaged in a farming business, and the corporation's primary asset consisted of a tract of farmland. The executor relied on an accountant to prepare and file the estate tax return, but the accountant was unfamiliar with Section 2032A and the executor was unaware of the existence of Section 2032A. The Service granted the extension to file the election, acting pursuant to Treas. Reg. §§301.9100-1 and 301.9100-3. A similar ruling was granted in 200438036.

§5.04 *How does section 2032A special use valuation operate?*

[A] Requirements for electing special use valuation

In addition to a decedent transferring real property to a qualified heir, the real property must be "qualified real property," meeting the qualified use requirements. There must also be "material participation" in the operation of the farm or business by the decedent or a member of the decedent's family.

[1] Qualified real property

In order to meet the requirements of qualified real property, the real property must be located within the United States and must be used for a qualified use by the decedent or a member of his family on the date of his death. IRC § 2032A(b)(1). The decedent or a member of the decedent's family must own an equity interest in the farm operation. The real property may be owned directly or indirectly through the ownership of an interest in a corporation, partnership, or trust, although in such a situation, the interest of the decedent must meet additional tests for qualification under IRC § 6166(b)(1) in addition to those under IRC § 2032A. The interest must meet those tests which qualify the interest as one in a closely held business on the date of the decedent's death and for a sufficient period of time to equal five out of eight years preceding the death. Treas. Reg. §20.2032A-3(b). Community property may qualify for special use valuation. For meeting the percentage tests to qualify for special use valuation, the entire value of the property is to be taken into account. Rev. Rul. 83-96, 1983-2 CB 156.

[2] Qualified use

Qualified real property must be used as either a farm for farming purposes or in a trade or business other than farming.

The term "farm" includes: stocks, dairy, poultry, fruit, fur-bearing animal and truck farms; plantations; ranches; nurseries; greenhouses or similar structures used primarily for the raising of horticultural or agricultural commodities; orchards; and woodlands. Treas. Reg. §20.2032A-3(b)(1).

"Farming purpose" is defined as: cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, sheering, feeding, caring for, training, and management of animals) on a farm; handling, drying, packing, grading or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and any planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market. IRC § 2032A(e)(5).

The term "trade" or "business" applies only to active businesses such as manufacturing, mercantile, or service enterprises, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The regulations state that, "the mere passive rental of property to a party other than a member of the decedent's family will not qualify," and a "trade or business is not necessarily present even though an office and regular hours are maintained for management of income producing assets." Also, there is no trade or business present if the activities are not engaged in for profit. Treas. Reg. §20.2032A(b)(1).

Property which is used for a qualified use includes residences on the qualified real property occupied on a regular basis by the owner, lessee, or an employee of the owner or lessee, for the purpose of operating the farm or business. Qualified real property also may include roads, buildings, and other structures and improvements functionally related to the qualified use. The buildings must be devoted to a qualified use in a trade or business. Treas. Reg. §20.2032A-(3)(b)(2). Those structures on the real property which are not related to its qualified use do not qualify for the special use valuation. *High Planes Enterprises*, 60 TC 158 (1973), *aff'd*, 496 F.2d 428 (10th Cir., 1974). Nevertheless, you may want to return the residence on Schedule A to avoid the recapture tax if sold separately from the other qualified real property.

Is a hunting lease necessarily a non-farm property use? The definition of "farming purposes" at IRC § 2032A(e)(5) includes the management of animals (not necessarily limited to domestic animals) on a farm or ranch and the harvesting of any agricultural commodity (which includes animals). One could reasonably conclude that the management of wild game and the sale of the right to third parties to harvest such gave is a farming purpose within the category of "use as a farm for farming purposes" under IRC § 2032A(b)(2). This conclusion may be in conflict with TAM 8516012 which required the estate to treat the ranch and hunting lease as two trades or businesses, one of which is a non-farming qualified use with special use value computed using the alternative five factor test for non-farm trades or businesses.

Mineral rights, oil and gas interests are not eligible for special use valuation. Purchase money mortgages and land contracts arising out of the sale of real property do not qualify for special use valuation. PLR 8221005. Crops do not qualify for special use valuation. PLR 8046012 and PLR 8105027. Unless a special election is made for coverage, timber will not qualify under IRC § 2032A(e)(13).

[B] Material participation

In order to qualify under Section 2032A for special use valuation, there must be material participation by the decedent or by a family member in the operation of the farm or the business on the land for five out of the eight years immediately preceding death, disability, or retirement. IRC § 2032A(b)(4). Whether material participation is present is a factual determination, and the activities which constitute material participation are different with different modes of ownership of both the property itself and of the business in which it is used.

The regulations say that "passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year." Treas. Reg. §20.2032A-3(a).

It is possible for the activities of the owner of rental real estate to rise to the level of material participation and take the income from the property out of classification as personal holding company rents. *See, Webster Corp*. 25 TC55 (1955). *See also*, PLR 9602017 and PLR9832009 where in the IRC § 6166 context where some types of rental activities and styles of management were ruled to be active businesses.

Material participation may be determined in the manner similar to that set forth in IRC § 1402a(1) for determining whether income is subject to self-employment taxes. Treas. Reg. §2032A-3(e).

Treasury Regulation §20.2032A-3 provides a safe harbor in determining the presence of material participation as well as factors to consider for determining the presence of material participation

when this safe harbor is not met. Material participation will be deemed to be present if the decedent is directly involved in fully managing the farm or business, and the decedent or a member of the decedent's family is actually employed in the management of the farm or business on a full-time basis or to such a lesser extent necessary to personally fully manage the farm or business. But if the involvement of the decedent is less than full time, the material participation must be pursuant to an arrangement providing for actual participation in the production or management of production where the land is used by a non- family member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but it must be formalized in some way capable of proof. Treas. Reg. §20.2032A-3(e)(1). The regulations also state that the activities of several individuals cannot be aggregated together to demonstrate material participation and a member of the family may materially participate provided the individual was a member of the family at the time the activities were engaged in. Treas. Reg. §20.2032A- 3(e)(1). In the absence of full-time management or management subject to an arrangement, the factors to be considered which will demonstrate material participation are:

- Physical work done on the farm or in the business and participation in management decisions. These are the principal factors to be considered. At minimum, the decedent and/or a family member must regularly consult or advise with the other managing party on the operation of the farm or business. The decedent and/or family members must at least participate in a substantial number of management decisions;
- Production activities inspected regularly by the decedent or a member of decedent's family;
- The presence of funds advanced by the decedent for the operation of the farm or business and a responsibility undertaken for a substantial portion of operating expenses involved in the farm or business by the material participant. In the case of farms, the regulations state that the furnishing by the owner of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor; and
- Maintaining a residence on the premises, when the real property is a farm, hotel or apartment building used as a trade or business. Treas. Reg. §20.2032A-3(e)(2).

At least one family member must actively materially participate at any given time because the activities of a number of family members cannot be aggregated in determining material participation. If non-family members participate in the operation of the farm or other business, the part-time activities by the decedent or family members must be pursuant to a provable oral or written arrangement providing for actual participation by the decedent or family members. Treas. Reg. §20.2032A-3(e)(1).

In order to satisfy the material participation requirement regarding a surviving spouse who receives qualifying property from a decedent, active management by the surviving spouse will satisfy the material participation requirement. Combinations of activities such as inspection of crops, review of crop lands, and marketing decisions constitute active management in farming operations.

Where the property is indirectly owned through a corporation, partnership, or trust, there must be an arrangement calling for material participation in the business by the decedent owner or a family member. Even full-time involvement in a situation where the business is indirectly owned must be pursuant to an arrangement between the business entity and the decedent owner or family member which specifies the services to be performed. Treas. Reg. §20.2032A-3(f).

Rev.Rul. 83-32, 1983-1 CB 226, held that a decedent who failed to pay self-employment taxes for any of the years of material participation is required to pay the self-employment taxes for any of the open three years. It may be good practice to file amended income tax returns and pay the back self-employment tax before filing the Form 706. This avoids upon audit the examiner thinking that the estate is waiting to see whether the IRS agrees that there was material participation and qualification under IRC § 2032(a) before paying the self-employment taxes.

[C] Percentage tests

There are two percentage tests that must be met in order for an estate to qualify for special use valuation.

At least **fifty percent (50%)** of the adjusted value of the decedent's gross estate must consist of the adjusted value of real and personal property that was held for a qualified use by the decedent or a member of his family on the date of his death and that was acquired from or passed from the decedent to a qualified heir. IRC § 2032A(b)(1)(A). Adjusted value is defined as the value of the gross estate reduced by the amount of any deduction allowed under IRC § 2053(a)(4).

Whether the properties of separate businesses may be aggregated for purposes of the fifty percent (50%) test will depend on the particular facts and circumstances. The adjusted value of real or personal property used for a qualifying use may not include personal property that is not connected with the real property that was being used for the qualifying use.

Estate of Geiger v. Comm., 80 TC 484 (1983). Community property may be valued under the special use valuation rules. To determine whether the property meets both percentage tests, to qualify for special use valuation, the entire value of the property is taken into account. Rev. Rul. 83-96, 1983 CB 156.

At least **twenty-five percent (25%)** of the adjusted gross estate must be qualified real property. However, the IRS has ruled that an estate does not have to elect special use valuation for all of the qualifying real property included in the decedent's gross estate so long as property for which the election was made had an adjusted value of more than twenty-five percent (25%) of the adjusted value of the gross estate. IRC § 2032A(b)(1)(B); PLR 8040016; Treas. Reg. §20.2032A-8(a)(2).

For purposes of satisfying both of these tests, the gross estate is computed under traditional valuation rules without regard to special use valuation then reduced by amounts allowed as deductions under IRC § 2053(a)(4). For the limited purposes of these percentage tests, both personal and real property must be valued under the highest and best use valuation method and reduced by amounts allowed as deductions under IRC § 2053(a)(4). Although personal property cannot be valued by the actual use method, it must be considered for purposes of meeting the percentage tests.

[D] Valuation methods

There are two valuation methods available for use for farms or closely held businesses that qualify for special use valuation. The estate tax returns may be amended to change the valuation once the special use election has been made. Rev. Rul. 83-115, 1983-2 CB 155. When hiring an appraiser for property that may qualify for special use valuation, make sure the appraiser can make a Section 2032A appraisal.

[1] Capitalization of rents or farm method

This method is available exclusively for valuing farms and is based on a formula of rentals, real estate taxes, and effective interest rates.

[a] Formula

The formula is the average annual gross cash rental for comparable land used for similar farming purposes and located in the same region as the farm, less the average annual state and local real estate taxes actually paid or accrued for the comparable land divided by the average annual effective interest rate charge for all new federal bank loans made to farmers and ranchers in the farm credit district in which the real property to be specially valued is located. The computation of each average annual amount is to be based on the five most recent calendar years ending before the date of the decedent's death. Treas. Reg. §20.2032A-4(a).

[b] Comparable land

Comparable land is defined as real property situated in the same locale as the specially valued property. The regulations indicate it may be necessary to break the property into segments and find different comparable properties where there are different uses or land characteristics present on the specially valued farm. Also, if the specially valued farm land has buildings or improvements on it that are to be specially valued, rented property with comparable buildings or improvements must be found. It is important to stress that when the property is broken up into segments and compared against several other properties, the actual comparable property and taxes must be used for each segment. There are also ten factors, which are not exclusive, listed in the regulations to help in determining comparability. These factors are (i) soil type; (ii) crop type; (iii) soil conservation techniques; (iv) probability of flooding; (v) slope of the land; (vi) carrying capacity for livestock; (vii) comparability of any timber; (viii) whether the property is a whole or segmented; (ix) existence of improvements; and (x) local transportation facilities. Treas. Reg. §20.2032A-4(d).

[c] Gross cash rental

Gross cash rental is defined as the total amount of cash received for the use of actual tracts of comparable land during the period of one calendar year. The amount of gross cash rental is not decreased by any expenses or liabilities involved with the farm operation or lease. The regulations state that "only rentals from tracts of comparable farm property which are rented solely for an amount of cash which is not contingent upon production are acceptable for use in valuing real property under Section 2032A(e)(7)." The rentals considered must be the result of arm's length transactions and rentals from property which qualifies for special use valuation cannot be used to compute the gross cash rentals under IRC § 2032A(e)(7). Treas. Reg. §20.2032-4(b)(1).

[d] Specific properties identified

The executor must identify to the IRS the actual comparable property and cash rentals from that property. Specific properties and the rents from those properties must be identified and reports of area-wide averages will not be accepted.

Treas. Reg. §20.2032A-4(d). The farm valuation method may not be used where there is no comparable land from which the average annual rental values can be computed or where the executor

elects to use the multiple factor method. Treas. Reg. §20.2032-4(b)(2).

[2] Multiple factor method for closely held businesses

The multiple factor method is the sole method for valuing closely held businesses. An estate may choose this method for farmland but this is not usually done due to the minimal guidance from the Service on this method. The executor may not choose just one factor in valuing the property, but rather requires consideration of all of the relevant factors in valuing the property, although some factors may be given more weight than others. Rev. Rul. 89-30, 1989-1 CB 274. To value qualified real property under the multiple factor method, the following factors are examined.

Capitalization of income. The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil, capacity, terrain configuration, and similar factors.

Capitalization of rents. Capitalized earnings value based on the fair rental value of the land for farm or closely held business purposes.

Assessed land values. Assessed land values may be used when the land is located in the state which provides a differential or use value assessment law for farm land or a closely held business.

Comparable sales. Comparable sales of other farm or closely held business land in the same geographic area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price.

Other factors. Other factors which fairly value the farm or closely held business use of the property may be used. IRC § 2032A(e)(8).

[3] Multiple factor method by default

In *Estate of Rebecca Wineman v. Comm*., TC Memo 2000-193, the estate elected IRC § 2032A (e)(7) special use election for ranch properties, but failed to provide the required documentation of actual cash rentals of comparable properties for the five-year period prior to the decedent's death. The tax court reasoned that pursuant to Treas. Reg. § 20.2032A-4(b)(2)(i) an estate that has elected special use valuation but failed to provide sufficient documentation to use the capitalization of rents method has, by default, elected to use the special use valuation multiple factor method of IRC § 2032A (e)(8).

[E] The election and agreement

[1] The election

An election under IRC § 2032A must be made on a timely filed estate tax return (Part 3 of Form 706). It is not necessary that all of the property in an estate that is eligible for special use valuation be included, so long as an amount is chosen that meets the 25 percent threshold test under IRC § 2032A(b)(1)(B), Treas. Reg. §20.2032A-8(a)(2). Once an election is made, it is irrevocable.

[2] The Schedule A-1

Attached to the election must be the consent agreement to special use valuation, discussed below, among all persons having an interest in the property and a completed Schedule A-1 giving certain information required by the regulations including:

(i) the decedent's name and taxpayer identification number as they appear on the tax return;

(ii) the relevant qualified use;

(iii) the items of real property shown on the estate tax return to be specially valued;

(iv) the fair market value of the real property to be specially valued under IRC § 2032A and its value based on its qualified use;

(v) the adjusted value of all real property that is in a qualified use that passes from the decedent to a qualified heir and the adjusted value of all real property to be specially valued;

(vi) the items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in the qualified use under IRC § 2032A and the total value of such personal property adjusted as provided under IRC § 2032A(b)(3)(B);

(vii) the adjusted value of the gross estate;

(viii) the method used in determining the special value based on use;

(ix) copies of written appraisals of the fair market value of the real property;

(x) a statement that the decedent and/or member of his family has owned all specially valued real property for at least five years out of the eight years immediately preceding the date of the decedent's death, disability or retirement;

(xi) any periods during the eight-year period preceding the date of the decedent's death during which the decedent or a member of his family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of IRC § 2032A(e)(6);

(xii) the name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property and the value of the property interest passing to each such person based on the fair market value and qualified use;

(xiii) affidavits describing the activities constituting material participation and the identity of the material participant or participants; and

(xiv) a legal description of the specially valued property. Treas. Reg. §20.2032A-8(a)(3).

[3] Protective election

A protective election may be filed with the estate tax return to specially value qualified real property when it is not certain that the property will qualify. This election does not extend the time for payment of taxes due. If the estate qualifies for special use valuation, then an additional notice of election meeting the requirements of a regular election under the regulations must be filed with an amended tax return within 60 days of the date of determination of qualification. The Service has indicated that a protective election may be used even though the estate meets the requirements for making an actual election at the time the return is filed. And an estate's attempt to make an actual election on a previously filed return does not preclude the estate from making a subsequent protective election. The election or protective election is deemed to be made on the last return filed before the due date, including extensions. PLR 8532003. In making a protective election, the executor must include in the notice of protective election a statement that a protective election under IRC § 2032A is being made pending final determination of values. There is no requirement that an agreement be filed with the protective election. The notice must include:

(i) the decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) the relevant qualified use; and

(iii) the items of real and personal property shown on the estate tax return that are used in a qualified use, and that pass to qualified heirs. Treas. Reg. §2032A-8(b).

[4] The agreement

[a] Required signatures

The consent agreement to special valuation by persons with an interest in the property must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death and must be attached to the election for special use valuation. For a qualified heir, the agreement must expressly consent to personal liability under IRC § 2032A(c)(5) in the event of certain early dispositions of the property or early cessation of the qualified use. For parties other than qualified heirs with interests in the property, the agreement must expressly consent to collection of any additional estate tax imposed under IRC § 2032A(c) from the qualified property. The agreement must be binding on all parties having an interest in the property and must designate an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service and must indicate the address of the agent. Treas. Reg. §20.2032A-8(c). Schedule A-1 contains the text of the required agreement. All the preparer needs to do is obtain the required signatures.

[b] Persons with an interest

A person having an interest in designated property is defined as an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. The regulations give examples of who such individuals are:

(i) owners of remainder and executory interests;

(ii) holders of general or special powers of appointment;

(iii) beneficiaries of a gift over in default of the exercise of those powers;

(iv) co-tenants, joint tenants, and holders of other undivided interests;

(v) trustees of trusts holding an interest in use valuation property. Treas. Reg. §20.2032A-8(c)(2).

[5] Substantial compliance

[a] 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. Comm., 57 F.3rd 1393, 1396-1397 (5th Cir. 1995), *reh'g denied* (Sept. 5, 1995), involved a Texas ranch and a $150,000 deficiency. The case gives an extensive analysis of IRC § 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*, 112 F.3d 1290, 1295-1296 (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 stipulated 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.

[b] 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.

[F] Benefit limits

After the IRC § 2032A special use value has been obtained, it must be compared with the fair market value of the property based on its highest and best use. The maximum value reduction is the difference between fair market value and the Section 2032A special use value for all qualified properties for which an election was made and was limited to $750,000. IRC § 2032A(a)(2). The $750,000 maximum exclusion will be subject to cost-of-living adjustments beginning in 1999, under The Taxpayer Relief Act of 1997.

[G] The recapture tax

Should an heir of the decedent dispose of the specially valued property or part of the property (other than to a family member) or if the property ceases to be used for a qualified use as a farm or closely held business during the qualified heir's lifetime within a recapture period measured from the decedent's death, the tax benefits realized by the estate through the special use valuation may be fully or partially recaptured by the imposition of additional estate taxes. IRC § 2032A(c).

[1] The recapture period and additional tax

The period in which the qualified heir is subject to additional estate taxes is 10 years from the date of death. The amount of the tax benefit subject to recapture is the excess of the estate tax liability that would have been incurred had the special use valuation not been obtained over the actual estate tax liability based on that special use valuation. The maximum recapture tax is the amount that the special valuation has saved the estate. A qualified heir is personally liable for that portion of the recapture tax imposed with respect to this or her interest in the specially valued property. That heir's liability will be extinguished when the recapture period lapses or when the heir dies without converting or disposing of the property. The additional tax will be due six months after the recapture event occurs. IRC § 2032A(c)(4).

[2] Triggering the recapture tax

The qualified heir is allowed up to two years before beginning qualified use of the property without triggering the recapture tax. But the recapture period does not start running until the qualified use begins. IRC § 2032A(c)(7).

The recapture tax will be imposed if any of these events occur:

(i) Disposition of the qualified property by the qualified heir. If the qualified heir sells any interest in the qualified property to one other than a family member during the recapture period, the recapture tax is imposed. A family member who purchases qualified real property from a qualified heir must sign a recapture agreement. IRC § 2032A(c)(1)(A), Rev. Rul. 85-86, 1985-1 CB 324. If specially valued property is involuntarily converted, there will be no recapture tax imposed. However, proceeds from the involuntary conversion must be reinvested in real property that is used for the same qualified use as the original specially valued property was. Also, qualified property which is exchanged tax-free in a like-kind exchange under IRC § 1031 will not be subject to recapture if the newly acquired property is employed for the same qualified use as the specially valued qualified property was. This is effective for exchanges occurring after 1981.

(ii) Cessation of qualified use. If the qualified heir ceases to use the property for the qualified use for which the special valuation was obtained, the qualified heir becomes liable for the recapture tax. IRC § 2032A(c)(1)(B) and (c)(6).

The IRS has yet to address whether a change of use of IRC § 2032A property elected under one type of qualified use to another type of qualified use is a

cessation of use. The phrase in IRC § 2032A(c)(1)(B) "ceases to use for the qualified use" can be construed to be confined to the type of activity asserted in the 2032A election as the qualified use. Possibly "the" in the phrase also implies the indefinite article "a", and "the qualified use" means any IRC § 2032A(b)(2) "qualified use."

Rental of the qualified property on a net cash basis generally is considered to be a cessation of qualified use. IRC § 2032A(c)(7)(E), added by the Taxpayer Relief Act of 1997, provides an exception that a surviving spouse or a lineal descendant of the decedent is not treated as failing to use qualified property for a qualified use where the spouse or descendant rents the property to a member of the family of the spouse or descendent on a net cash basis. This exception added in 1997 is effective retroactively back to 1976, the original effective date of IRC § 2032A. The Taxpayer Relief Act of 1997 made no provision for lineal descendants who had already paid a recapture tax because a net cash lease by the lineal descendant to a family member was a cessation of qualified use and for whom the statute of limitations on making a refund request had already expired. The Economic Growth and Tax Relief Reconciliation Act of 2001, Section 581, provides that if, on June 7, 2001 (or at any time within one year of that date), a refund or credit of any overpayment of tax resulting from the application of IRC § 2032A(c)(7)(E) is based, the refund of the overpayment will be allowed if a claim for refund is filed before June 7, 2002.

(iii) Failure to satisfy the equity interest aspect of the qualified use test. If the qualified heir ceases to have an equity interest in the qualified property under the qualified use test, the recapture tax is imposed. IRC § 2032(c)(1)(B), Treas. Reg. §20.2032A-3(b)(1).

(iv) Failure to satisfy the material participation requirements after the decedent's death. If during any period of eight years after the decedent's death there were periods which aggregate to greater than three years in which there was no material participation by the qualified heir or a member of his family in the operation of the farm or business, the qualified heir is liable for the recapture tax. IRC § 2032A(c)(6)(B)(ii).

[3] Death of qualified heir

If the qualified heir dies during the recapture period, the recapture tax period expires and there is no recapture tax imposed as to that qualified heir's share.

[4] Special lien on special use property

IRC § 6324B provides a special lien on property on which special use valuation under IRC § 2032A has been elected. Where this lien applies, the special estate tax lien under IRC § 6324 does not apply.

The amount of the lien is the "adjusted tax difference" attributable to the special use election, which is the difference between what the estate tax would have been without the special use election and what the tax was with the special use election.

The lien arises in favor of the United States on the property to which the special use election applies. This lien must be filed for the lien to have priority.

The qualified heir may make written application to the district director for a certificate of discharge of any or all property subject to such lien, and give a bond or other security in an amount or value determined by the district director as sufficient security for the maximum potential liability for additional estate tax with respect to such interest.

[H] Further information

Kelley, Estate Planning for Farmers and Ranchers (West Group).

6 SCHEDULE B - STOCKS AND BONDS

§6.01 *When completed*

According to the instructions, Schedule B must be completed and filed when the gross estate contains any stocks or bonds. Instructions, p. 12. Actually, the gross estate may include stocks or bonds that are not reported on Schedule B. Mutual funds are usually reported on Schedule B.

[A] Jointly held

Jointly held stocks and bonds are properly reported on Schedule E. Form, Schedule E, p.17 and Schedule B, p. 12.

[B] 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. Form, Schedule G, p.21.

[C] Subject to power of appointment

Stocks and bonds subject to a power of appointment are properly reported on Schedule H. Form, Schedule H, p.21.

[D] 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. Form, Schedule F, p.20.

§6.02 *Valuation of stocks and bonds in general*

For valuation for estate tax purposes there are three basic types of securities: closely held, publicly traded, and blocks of publicly traded.

[A] Closely held

Closely held securities, for which there are no public trades, are usually appraised by a recognized appraiser, if they are significant enough. If the interest is not substantial, the preparer may rough out a value for the return. When the decedent was a minority owner, there may be other owners who have recently died and you can piggyback off of their appraisal, or there may be trades that you can use.

[B] Publicly traded

Publicly traded securities are valued based upon their trading prices. The Instructions, p. 13, contain this admonition: "In valuing listed stocks and bonds, you should carefully check accurate records to obtain values for the applicable valuation date."

[C] Blocks of publicly traded

In this type of unusual situation, an appraiser is used to obtain the blockage discount. See discussion below in "Blockage discounts."

§6.03 *Stocks*

[A] Required information

For stocks, the Instructions, p. 12, require the following information (which is the same information required by the regulations, Treas. Reg. §20.6018-3(c)(2)):

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 [not requested in regulations]
i. Principal business office, if stock is unlisted.

The author frequently skips item g., the exchange where listed, when the value of publicly traded stocks comes from a valuation service, discussed below. Each item should be numbered consecutively in the left-hand column. Instructions, p. 12.

[B] CUSIPs

The CUSIP (Committee on Uniform Identification Procedure) number is a nine digit number assigned to all publicly traded securities. The best source to provide the CUSIP number may be the decedent's broker. Another way is to subscribe to Standard and Poor's Dividend Record, 55 Water Street, New York, NY 10041, for around $70.00 and get CUSIP's in print. Financial Data Services, Inc. at financialdata.com sells a CD with historical prices, and the CD also has CUSIPs. More information is available in Appendix D.

[C] Dividends

Dividends are to be separately listed on each stock. Instructions, p. 12.

[1] Decedent stockholder of record

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 separately. Instructions, p. 12.

[2] 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. 12; Treas. Reg. §20.2031-2(i).

[3] 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 includable in the gross estate. Instructions, p. 12.

[4] Community property

Depending upon state law for a married decedent, dividends from stocks, even separately owned stocks, may 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.

[5] Income in respect of a decedent

Dividends are an income in respect of a decedent item also subject to income tax.

[D] Valuing restricted securities

In *Estate of McClatchy v. Comm.*, 147 F.3d 1089, 1093 (1998), the Ninth Circuit held that 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. 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, 106 TC 206

(1996), the Ninth Circuit noted that 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.

§6.04 *Bonds*

[A] Required information

For bonds, the Instructions, p. 12, require the following:

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.

The regulations require the same information, but instead of the CUSIP number, request the series number if there is more than one issue. Treas. Reg. §20.6018-3(c)(2). Each item should be numbered consecutively in the lefthand column. Instructions, p. 12.

[B] Interest

List interest rate and amount on each bond separately. Interest is an income in respect of a decedent item.

For a married decedent, interest from bonds, possibly even separately owned bonds in a community property state like Texas, 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. One must have a working knowledge of the marital property laws of the applicable state.

[C] 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. 12.

§6.05 *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. 12.

§6.06 *Valuation*

[A] 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).

[B] Sales on valuation date

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. 13; Treas. Reg. §20.2031-2(b)(1).

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. 13; Treas. Reg. §20.2031-2(b)(2).

[C] No sales on valuation date

Where there are no sales on the valuation date, the Instructions, p. 13, give two alternate methods for determining the value. These methods are used where the valuation date falls on a weekend or a holiday.

[1] 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. 13.

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). The Instructions, p. 13, provide this illustration:

> For example, assume that sales of stock nearest the valuation date (June 15) occurred 2 trading days before (June 13) and 3 trading days after (June 18). On those days the mean sale prices per share were $10 and $15, respectively. Therefore, the price of $12 is considered the FMV of a share of stock on the valuation date. If, however,

> on June 13 and 18, the mean sale prices per share were $15 and $10, respectively, the FMV of a share of stock on the valuation date is $13.

Open ended mutual funds are excepted from these calculations and instead use the closing value of the last previous trading day. See "Special rule for mutual funds", below.

[2] 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. 13; Treas. Reg. §20.2031-2(c).

[3] 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. 13.

[4] 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).

[a] Selling prices unavailable

The regulations state that few or sporadic sales at or near the valuation date may not indicate fair market value. *Id.*

[b] 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. The blockage discount is explicitly approved by the regulations:

> If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.
>
> Treas. Reg. §20.2031-2(e).

Decedent's stock is valued as a block, rather than share-by-share, and an appraiser will be required to determine the discount. See, *Estate of Sydney M. Friedberge*, 63 TCM 3080 (1992). Data in support of the discount needs to be submitted with the return. *Id. See, Estate of Dorothy 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%.

[c] Controlling interest

The IRS adjusts value upward for a control 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."

Treas. Reg. §20.2031-2(e).

[5] Securities on multiple exchanges

The Instructions, p. 13, 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.

[6] Special rule for mutual funds

The fair market value of a mutual fund, more technically known as an "open end investment company" has a special rule. The "last public redemption price quoted by the company" read "the closing value" for the date of death will be presumed to be the applicable public redemption price and the fair market value for the date of death. The same will apply to the alternate valuation date if the alternate valuation method is elected. Where there is "no public redemption price quoted by the company for the applicable violation date (e.g., the valuation date is a Saturday, Sunday, or holiday), the fair market value of the mutual fund share is the last public redemption price quoted by the company for the first day preceding the applicable valuation date for which there is a quotation." Treas. Reg. §20.2031-8(b)(1). Mutual funds are one instance in which closing values determine fair market value.

[7] Brokers quotations

When obtaining quotes from brokers, use caution, because for publicly traded stocks and bonds (not mutual funds) 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. 13; Treas. Reg. §20.2031-2(b)(1).

[8] Valuation services

The most cost effective way to obtain values is to use a valuation service that provides the information by fax 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 D, "Using Technology to Draft Estate Tax Returns," for names and addresses of several valuation services.

For valuing just one or two stocks, retain the *Wall Street Journal* that has the quotations for the date of death. (If the decedent died on Thursday, retain the *Journal* published on the next business day.) For death on a weekend or holiday, retain the edition for the first day after the weekend or holiday and the next day thereafter.

A practical way to obtain historical stock quotes on the Internet is to use http://bigcharts.marketwatch.com/historical/.

[9] Catastrophic events discounts

If the decedent died on September 11, 2001, or soon thereafter is the estate entitled to a catastrophic events discount? Subsection a., above, provides a method of calculating the values of stocks when the stock market is closed due to weekends and holidays, but it may be inadequate to account for the sudden drop in prices due to catastrophic events and longer market closings. The highly volatile nature of the stock market requires daily prices to obtain fair market value. When death occurs while a catastrophic event occurs or during a period when the markets are closed for more than three days, the gradual decline calculated based on the instructions in subsection a. may not adequately capture the actual decline. It seems to your author that one might value the stock under the valuation methods described in subsection a., but take a catastrophic events discount to reach the value as of when the markets reopened, because any drop due to a catastrophic event probably is sudden itself and not a gradual coast down.

Also, see the discussion on catastrophic economic events at the subsection entitled "Catastrophic events discounts," in Chapter 4, "Schedule A, Real Estate," and the subsection entitled "Economic losses," in Chapter 16, "Schedule L, Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims."

§6.07 *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.

The Instructions, p. 13, 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.

The regulations require "if the stock is unlisted, the location of the principal business office and state in which incorporated and the date of incorporation." Treas. Reg. §20.6018-3(c)(2).

IRC § 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.

[A] Selling prices unavailable

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

[1] 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. 12.

[2] 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).

[3] 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.

[a] Liquidation expenses

The courts have held that it is inappropriate to

consider the selling expenses to dispose of the underlying assets. *Estate of Cruikshank*, 9 TC 162 (1947).

[b] Capital gains taxes

See the discussion of the *Davis* case in the section entitled "Discount for capital gains tax," in Chapter 2, "Valuation."

[B] Rev. Rul. 59-60

The IRS talisman for closely held business valuation is Rev. Rul. 59-60, 1959 CB 237, modified by Rev. Rul. 65-193, 1965 CB 370; Rev. Rul. 77-287, 1977-2 CB 319; and Rev. Rul. 83-120, 1983-2 CB 170. All available financial data, as well as all relevant factors affecting the fair market value, should be considered. The fundamental factors, not all inclusive, that require "careful analysis" are set forth. The IRS gives its comments on valuation of closely held businesses in its course book for its agents, *IRS Valuation Training for Appeals Officers*, hereinafter "*Coursebook*."

(i) *The nature of the business and the history of the enterprise from its inception*

The history should include "the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales record and management." Rev. Rul. 59-60, Sec. 4.02(a). One must understand a business' past to fully understand its present.

(ii) *The economic outlook in general and the condition and outlook of the specific industry in particular*

> [C]onsider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise. *Coursebook*, p. 7-23.

(iii) *The book value of the stocks and the financial condition of the business*

Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation. *Id*. at 7-24.

(iv) *The earning capacity of the company*

> Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest. *Id.*

(v) *The dividend-paying capacity*

According to the ruling, dividend paying capacity is a factor to be considered, but dividends *actually paid* may not have any relation to dividend-paying capacity. *Id.* at (e).

(vi) *Whether or not the enterprise has good-will or other intangible value*

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets. *Id.* at (f).

Does the IRS ruling confuse goodwill with the ability to pay net income? Does an analysis of net income, properly done, obviate the need to consider goodwill?

(vii) *Sales of the stock and the size of the block of stock to be valued*

> Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in a unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock. *Id.* at (g).

Is there such a thing as a control premium, or is a control premium just an absence of minority discount or a diminution of the discount?

The IRS has not had perfect success in disregarding sales near the valuation date. In *Morrissey v. Comm.* 243 F.3d 1145, (9th Cir. 2001) *reversing Friedlander Kaufman v. Comm.*, 1999 WL 185166 (U.S. Tax Ct.), 77 TCM (CCH) 1779 (1999),

the decedent owned a 19.86% stock interest in a family owned closely held business. Shortly after decedent's death, a family member commissioned a stock appraisal and purchased stock from two other family members at the appraised price approximately two months after the estate's valuation date. The estate based the value of the decedent's stocks on their stock sales. The IRS determined a deficiency and the Tax Court ruled that the sales were not arm's length. The appeals court reversed, because the sales constituted evidence of the value of the estate's stock because they were within 2 months of the alternate valuation date, they involved willing and knowledgeable buyers and seller, were not forced or distressed, and the parties were not so closely related and indicated no intent to make a gift.

(viii) *The market price of stocks of a corporation engaged in the same or a similar line of business having their stocks actively traded in a free open market, either on an exchange or over- the-counter*

> Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds of debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion. *Id*. at (h).

(ix) *Valuation approaches*

Rev. Rul. 59-60 emphasizes the most common methods of valuation.

[a] Adjusted book value

Also known as "net tangible asset method," it is computed by taking the book value of the business and making adjustments for: (a) fair market value of assets, (b) excess depreciation, and (c) other "deceptive" items such as LIFO reserves. Adjusted book value is useful for the valuation of investment companies such as real estate holding companies, and companies about to be liquidated.

[b] Comparable price

This method requires an assumption that the value of other companies are comparable to the closely held business being valued. Lack of comparables, suggested to be at least three, may cause the method to be inappropriate in the subject case.

[c] Excess earnings

This method is based on the theory that the value of net tangible assets plus the value of excess earning (goodwill) equals the value of the business. From adjusted book value, earnings on unusual items, such as investment income derived from other than operations, is removed to find "adjusted earnings."

[d] Capitalization of earnings

In this method, the five-year weighted average of adjusted earnings is capitalized. It may be a better indication of value if greater than the book value.

(x) *Other valuation approaches.*

Since the issuance of Rev. Rul. 59-60, two additional valuation methods have come into vogue.

[a] Discounted future earnings

Future earnings are projected for a period of years, usually five. A discount rate is applied to each of the years' estimated earnings to determine their present values that, when added together give the discounted future earnings value.

[b] Discounted cash flow

Net profits after tax are estimated for the desired future period and added to the depreciation and amortization, resulting in cash flow before debt service and other capitol requirements.

[1] Non-operating 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 VIII. C.

[2] 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).

[3] Fractional interest discounts

Gifts of closely held corporate stock on six valuation dates were involved in *Bernard Mandelbaum v. Comm.*, 69 TCM (CCH) 2852 (1995). 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. Comm.*, 91 F.3d 124 (3rd Cir. 1996).

Twenty-five percent lack of marketability discount and ten percent minority discount were allowed in *Wheeler v. U.S.*, 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 James Barudin*, TC Memo 1996-395. 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.

[C] Aggregation

[1] QTIP trust aggregation

In LTR 9550002, a block of closely held stock owned outright by the decedent was aggregated with the stock held in a QTIP trust includable 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 includable in the decedent's gross estate under IRC § 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*, 84 F.3d 196, 198-199 (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 § 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 §

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. *Id*. at 199.

In *Estate of Harriet Mellinger v. Comm*., 122 TC 26 (1999), the tax court held that a block of publicly traded stock held in the decedent's revocable trust and includable in her gross estate under IRC § 2033 was not aggregated for valuation purposes with additional shares of the same stock held in a QTIP trust includable under IRC § 2044. The IRS has acquiesced and this issue should be laid to rest. AOD CC-1999-006.

[2] General power of appointment trust aggregation

In FSA 200119013 the IRS ruled that stock owned outright by the decedent should be aggregated with stock held in a general power of appointment marital deduction trust created by the decedent's pre-deceased wife. The IRS views these trusts much differently than it views QTIP trusts, as does the Tax Court, which in *Fontana v. Comm*., 118 TC No. 16 (2002), held that for federal estate tax valuation purposes stock subject to a testamentary general power of appoint of decedent must be aggregated with stock the decedent owned outright.

[D] 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.

[1] Waiting till audit or litigation

A quality independent expert appraisal should be obtained as part of the process of preparing to file the federal estate tax return, rather than waiting until an audit or litigation. An expert's report will obviously carry more credibility when the return reports that value rather than when the report is written to support a value already returned. Certainly when the appraisal report gives a value less than the returned value, the returned value will be taken as a statement against interest making it difficult if not impossible to use the lower appraisal value. In *Estate of Hall v. Comm*., 92 TC 312, 337-38 (1989) it was held that a valuation amount reported on an a taxpayer's return is a deemed admission. *Estate of Leichter v. Comm*, TC Memo 2003-66, was a case where the returned value of a closely held business was $2,091,750 and based on an appraisal, while the service's expert contended the value was $2,150,000, but the estate argued that the appraisal attached to the return was erroneous or flawed and the value at most was $800,000. The Tax Court found "the record replete with evidence that value reported on the estate tax return was correct." *Id*

[2] Skeletal or complete

Some appraisal reports are skeletal, giving a statement of the purpose, a brief explanation of the process, and the conclusion. The financial data and the detail on the report, such as capitalization rates and discounts, are not included in the report, but rather remain in the "appraiser's file." A full and complete report has all of the financial data used on the particular business, as well as the reasons for selecting capitalization rates and discounts, and will set forth most if not all of the items in the appraisal review checklist below. Sometimes, the appraiser will give a low fee to get the business, prepare a skeletal report, and then try to bill at high hourly rates upon audit. The skeletal report may more likely draw the audit than will the full and complete report. Because the appraisal provides the basis for any valuation discounts, especially in litigation, the full and complete report may better serve the purpose for which an appraisal is sought.

[3] Appraiser qualifications

An appraiser, for tax purposes, is anyone who states in the appraisal report that the person (i) holds himself or herself out to the public as an appraiser, (ii) is qualified to make appraisals of the property being valued, and (iii) understands he or she may be subject to penalties for false or fraudulent overvaluation or undervaluation.

Choose an appraiser with qualifications as an objective business valuation expert that you know either from personal experience or by reputation uses generally accepted valuation methodology to reach sound financial conclusions. Consider the entire return process: if the return is audited will this appraiser be able to defend his or her report and conclusions in the audit process, and if this return is litigated will this appraiser give good expert testimony under both direct examination and cross examination convincingly explaining (i) the appraiser's qualifications as an objective business valuation expert, (ii) the scope of the business valuation report, (iii) the valuation methodologies, and (iv) the financial conclusions.

Here is an alphabet soup of business valuation accreditations.

ABV – Accredited in Business Valuation. American Institute of Certified Public Accountants (AICPA). Requirements: Current CPA license and membership in AICPA; pass one-day examination; have substantial involvement in at least 10 business valuation engagements.

ASA – Accredited Senior Appraiser. American Society of Appraisers (ASA). Requirements: College degree or equivalent; complete four courses and pass examinations or hold ABV designation; complete ethics courses and pass Uniform Standards of Professional Appraisal Practice examinations; submit and have accepted two valuation reports to Board of Examiners; have five years of full time experience or equivalent.

CVA - Certified Valuation Analyst. National Association of Certified Valuation Analysts (NACVA). Requirements: CPA license; five-day course and exam with sample case.

CBA - Certified Business Appraiser. Institute of Business Appraisers (IBA). Requirements: Four years of college; 3.5 hour examination; one report for peer review; submission of two business appraisal reports showing professional competence.

MCBA - Master Certified Business Appraiser. Institute of Business Appraisers (IBA). Requirements: IBA member with CBA designation; 10 years of experience or publication/lecturing credit plus four work references from CBAs.

BVAL - Business Valuator Accredited for Litigation. Institute of Business Appraisers (IBA). Requirements: business appraisal designation from IBA, AICPA, ASA or NACVA,; seven-day workshop and examination; letter of reference from attorneys or 16 hours of legal education in specific area of testimony.

CVB - Charter Business Valuator. Canadian Institute of Chartered Business Valuators. Requirements: College degree, six courses, assignments and examinations; membership entrance examination; two years of full-time experience.

In Estate of *Thompson v. Comm.*, TC Memo 2004-174, the Tax Court faced with appraisals of a closely held business interest of $1.75 million by decedent's estate and $32.4 million by the Service, stated "the estate's experts impress us as too inexperienced, accommodating, and biased in favor of the estate" and the Service's "expert appears to have selected his comparable companies in a casual manner,"...made significant errors in his calculations and analysis, and he made questionable and inadequately explained adjustments." The Tax Court performed its own analysis and produced a value of $13.5 million.

[4] Appraiser engagement letters

In the event of audit or litigation, any correspondence between the preparer and the appraiser may be discovered by the IRS. Also, if the appraiser's report is used to determine value for purposes of estate distribution among adverse beneficiaries, then any correspondence may be discovered. Review any engagement letter with an appraiser with the idea in mind that someone adverse to the estate may be reading that letter. Use Checklist 4, Appraiser Engagement Letter Checklist, when reviewing the proffered letter before it is signed. When negotiating the fees and memorializing them in the letter, get the fees for date of death, alternate valuation and funding appraisals agreed in the initial contract so you do not overpay by separately negotiating each.

Before the engagement letter is signed, review with the appraiser, the appraiser's expectation as to making an oral report, retention of drafts, notes and e-mails. It may be that the appraiser feels bound by requirements of professional societies as well as office policies and procedures. Know what these are before the engagement letter is secured to avoid unpleasant surprises if an audit or litigation arises.

[5] Documents needed by appraiser

Checklist 5, Documents for Appraiser. Checklist, is a checklist that the preparer can provide the executor or the person with the business interest being appraised to assist that person in gathering the documents needed by the appraiser. An appraiser may provide its own checklist, and this checklist can be used to get a jump on collecting the required information. Because the documents needed for a partnership or a corporation or any type of closely held business interest are similar, this checklist can be used for any closely held business interest with slight adaptation.

Checklist 4
APPRAISER ENGAGEMENT LETTER CHECKLIST

- ❑ Does appraiser work for the executor or the preparer?
- ❑ Is executor or preparer responsible for the fee?
- ❑ What will the appraiser appraise?
- ❑ Who is responsible for providing required information to the appraiser?
- ❑ When will information be provided?
- ❑ What is the purpose of the appraisal report?
- ❑ What are the appraisal fees? Fixed Fee? Hourly?
- ❑ What are the rates for deposition or trial testimony?
- ❑ What is fee for AVD appraisal?
- ❑ Is a retainer required? In what amount?
- ❑ When is payment for services due?
- ❑ What expenses will be billed?
- ❑ Will appraiser report orally to preparer before preparing written report?
- ❑ When is the appraisal report due?
- ❑ Does appraiser agree to not work for another party, Including IRS, as to the same asset?

[6] 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. When reviewing an appraisal report, initially preferably unsigned and in draft form, look for the items set forth in Checklist 6, Business Appraisal Review Checklist.

The Internal Revenue Service has issued Business Valuation Guidelines applicable to the Service's appraisers performing business valuations. If a controversy with the Service arises over an appraisal report prepared by an expert on behalf of the Service, compare and contrast the appraisal report with the guidelines to determine if there is anything that can be used to impeach the Service's own expert. Appendix F contains a copy of the Services' checklist for business appraisals.

Checklist 5
Documents for Appraiser Checklist

LEGAL DOCUMENTS

- ❑ Articles of incorporation, partnership agreements, articles of organization
- ❑ Buy-sell agreements
- Deeds, leases and mortgages
- ❑ Employment agreements
- ❑ Franchise or licensing agreements
- ❑ Long-term contractual agreements with customers or suppliers

FINANCIAL INFORMATION

- ❑ Tax returns for the past five years
- ❑ Financial statements for the past five years
- ❑ balance sheet
- ❑ income statement
- ❑ statement of cash flow
- ❑ statement of changes in stockholders' equity or capital accounts
- ❑ Current interim financial statements
- ❑ Schedule of dividends, distributions and bonuses
- ❑ Aged receivables and payables lists
- ❑ Real estate and equipment lists and their depreciation schedules
- ❑ Inventory list
- ❑ Budgets and projections
- ❑ Lists of loans to and from officers, directors, managers and shareholders

OTHER

- ❑ History of the company
- ❑ Management profile
- ❑ Customer and supplier lists
- ❑ Stockholder or partner lists, including age, date and cost of acquisition and relationship to management and each other
- ❑ Past transactions in the stock or offers to buy the business interests
- ❑ Prior appraisals of the business entity or of major assets: real estate or fixed assets
- ❑ Promotional information

[7] Relevant discount studies

In the area of valuation discounts for family limited partnerships (FLPs) the Tax Court may not find itself limited to the discounts in the appraisals of the taxpayer or the Service. In *Peracchio v. Comm.*, T.C. Memo 2003-280, the Tax Court required the appraisers to demonstrate exactly how individual companies in an empirical study compared to the case at hand. Dissatisfied with both experts' analyses, the judge actually performed his own independent analysis to quantify the FLP's minority interest and marketability discounts. An appraisal will fare better in Tax Court if the appraiser takes the time to dissect empirical studies and eliminate companies dissimilar to the FLP at hand. The appraisal should connect the market evidence to the FLP's specific characteristics.

Factors to include are relevant state law, partnership agreement transfer restrictions, diversity and liquidity of underlying assets, financial performance, expected and historic cash distributions, size of the interest being valued, access to information, and quality of management.

In *McCord v. Comm.*, 120 TC No. 13, eight judges uncovered flows in the methods used by the appraisers for the IRS and the taxpayers. The judges found better and more relevant investment company guideline groups of marketable equities and municipal bonds to determine minority interest valuation discounts.

[8] In litigation

Frequently, when the estate has its expert's report and the IRS has its expert's report, there is a tendency for the Tax Court to exercise Solomon like zeal and divide the baby, arriving at a figure that is approximately half way between the two experts' figures. Yet, that is not the "baseball arbitration" position stated in *Buffalo Tool & Die Mfg. Co. v. Comm.*, 74 TC 441 (1980).

> As the Court repeatedly admonished counsel at trial, the issue is more properly suited for the give and take of the settlement process than adjudication. See *Messing v. Commissioner*, 48 TC at 512. The existing record reeks of stubbornness rather than flexibility on the part of both parties, based upon "an overzealous effort *** to infuse a talismanic precision" into their respective views as to valuation. See *Messing v. Commissioner*, 48 TC at 512. We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of–the-road compromise which we suspect each of the parties expects the Court to reach. If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court.

[9] Further information

Shannon Pratt, THE LAWYER'S BUSINESS VALUATION HANDBOOK, American Bar Association.

[E] Selling prices available

Sales prices near the valuation date may provide the best indication of value, but with closely held stock, many sales will be between related parties and not conducted at arm's length. Such sales are not a good indication of value.

In *Estate of Welch v. Comm.*, TC Memo 1998-167, Tax Court treated as non-probative a sale occurring between co-executors twelve months after the valuation date. The co-executors were siblings and the purchase price was approximately the same as the value indicated on the estate tax return.

In *Estate of Disanto v. Comm.*, TC Memo 1999-421 the Tax Court refused to find that a redemption occurring two years after the decedent's death was indicative of value. The company was controlled by the decedent's brother and the redemption occurred with the decedent's children. The parties were related and the redemption price was in excess of the then current valuations. Emotional factors in the transaction indicated that the transaction was not consummated at arm's length.

[F] Closely held business interests during administration

Closely held business interests will be valued based upon aspects of the organizational documents as well as the manner in which the business, or lack thereof, was conducted during the decedent's life. This will be particularly true for interests in family limited partnerships and limited liability companies. As sometimes said, "If you don't respect your family limited partnership, don't expect the IRS to respect it either." As sometimes said, "If you don't respect your family limited partnership, don't expect the IRS to respect it either." These facts will be largely set by the time of administration and preparation of the estate tax return after the decedent's death, but the recognition of the business entity and the valuation itself can depend upon how the personal representatives and the beneficiaries handle the decedent's interests during administration.

The business entity, whether a partnership or limited liability company, must be administered like a business entity rather than like a trust. *Schauerhamer v. Comm.*, TC Memo 1997-242; *Harper v. Comm.*, TC Memo 2002-121; *Estate of Thompson v. Comm,*. TC Memo 2002-246, *aff'd Turner v. Comm.*, No. 03-3173 (3rd Cir. 2004); *Strangi v. Comm.*, 85 TCM (CCH) 1331 (2003); *Hillgren v. Comm.*, TC Memo. 2004-46. *Turner v. Comm., supra.*, states that the entity must engage in business transactions, which suggests that the records should support business transactions and a non-tax business purpose. While correspondence of a non-tax purpose in forming the transaction may be viewed as self-serving, any documents tending to

prove such non-tax and business purposes should be preserved. This does not mean that documents tending to show a tax-avoidance purpose should be destroyed, but rather is a recognition that any set of facts will be combinations of good and bad facts from the estate's viewpoint and good facts should be preserved.

All formalities of the partnership or entity must be observed, *Kimble v. US*, 93 AFTR 2d 2004-2400 (5th Cir. 2005), both in establishing the entity and it operating it. Make sure that the title to property is transferred, *Hillgren v. Comm., supra.; Harper v. Comm., supra.; see also Church v. US*, 268 F.3d 1063 (5th Cir. 2002). All organizational documents and documents proving transfers to the corporation need to be preserved; *Shepherd v. Comm.*, 115 TC 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); *Estate of Jones v. Comm.*, 116 TC 121 (2001); *Senda v. Comm.*, TC Memo 1004-160. To the extent they would be completed by the decedent in the ordinary course of business they should be completed during administration. *Church v. US, supra*.

In *Turner* an implied agreement, requiring inclusion in the decedent's estate, was found in that decedent transferred substantially all of his assets and did not retain sufficient assets to meet his fixed living expenses, that his children sought assurances from financial advisors that decedent would be able to withdraw assets from the partnerships to make gifts to family members, and that the partnerships in fact made such distributions to decedent. Do not immediately reimburse decedent's expenses nor fund the estate to pay debts and expenses of administration. *Hillgren v. Comm., supra; Harper v. Comm., supra; Estate of Abraham v. Comm.*, TC Memo 2004-39; *Schauerhamer v. Comm., supra.*

Meetings of partners or limited liability company members should be held regularly and the discussions and decisions recorded in meeting minutes. Even more so, minutes during the decedent's life to the extent made should be preserved.

The entities should have financial statements and tax returns. *Senda v. Comm.*, TC Memo 2004-160. Make sure the financial statements and tax returns continue to be made during administration and complete any that should have been completed during life. Books and records and partnership tax returns should be retained. Make sure that amounts have been properly credited to capital accounts, *Kimble v. US*, 93 AFTR 2d 2004-2400 (5th Cir. 2005), *Harper v. Comm, supra*, and there should be no commingling of assets, *Hillgren v. Comm., supra.*

The decedent should not pay all of the costs to create the business entities. These costs should be reimbursed by the business entity or treated as liabilities by the entity. *Senda v. Comm.,supra*.

The limited partnerships and limited liability companies should not be unwound during administration or the entity will look like a testamentary vehicle; *Hillgren v. Comm., supra.* A sale of an interest from one beneficiary to another beneficiary will be strong evidence that entity should not be recognized and will create evidence of fair market value in the sales price paid. Distributions from funds to pay estate taxes may be viewed as disguised sales or liquidations. *Harper v. Comm., supra*.

Beware of representing everyone and their brother as legal counsel. Make sure each entity decides who prepares books of account and tax returns.

§6.08 *Securities with no value*

The Instructions, p. 11, 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.

§6.09 *Buy-sell agreements*

A buy-sell agreement may be binding under local law, but it does not necessarily fix the value for federal estate tax purposes. Agreements entered before October 9, 1990, and not substantially modified on or after that date, may be disregarded by the IRS as a tool to shift wealth at death, unless the buy-sell agreement represents a bona fide business arrangement. *See, Estate of Joseph Lauder*, 60 TCM (CCH) 997 (1990); 64 TCM (CCH) 1643 (1992); Treas. Reg. §20.2031-2(h); Rev. Rul. 59-60, 1959-1 CB 237.

For buy-sell agreements entered or substantially modified after October 8, 1990, when family members of the decedent are also parties to the agreement, the IRS may ignore the buy-sell valuation unless (i) it is a bona fide business arrangement; (ii) it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (iii) its terms are comparable to similar arrangements entered into by persons in an arm's length transaction. IRC § 2703(b)(3). Under Treas. Reg. §25.2703-1(b)(3), a buy-sell agreement is presumed to meet these three requirements if more

than 50% by value of the property subject to the buy-sell agreement is owned by unrelated parties.

§6.10 *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] What are options?

A stock option is a contract giving the holder the right (but not the obligation) for a specified period to either buy (usually the case) or sell a specified number of stock shares at a predetermined price (the exercise price). An option contract to buy is a "call," and an option contract to sell is a "put." Options have value when the exercise price is lower than the market price, at which point they are said to be "in the money." An option cannot have a value lower than zero because the holder is not obligated to buy the stock if the option is not in the money. A first step with stock options is determining what kind of options the decedent owned. There are basically two types of options: unrestricted and restricted.

[B] Unrestricted options

Unrestricted options are traded in an established options market, such as the Chicago Board of Trade, and the market place determines their value.

[C] Restricted options

Restricted options cannot be publicly traded and have limited transferability. Employee stock options are a type of restricted option and they fall into two categories: incentive stock options and nonqualified stock options. Incentive stock option have favorable tax treatment, but restrictions limit their transferability. Nonqualified stock options typically have fewer restrictions and are more easily transferred.

[D] How options are valued

There are three main approaches to valuing stock options: intrinsic value method, market approach, and Black-Scholes model.

[1] Intrinsic value method

Basically, intrinsic value is the difference between the exercise price and the market price on the valuation date, and under this approach, options have value only when the exercise price is lower than the market price.

Unrestricted options may have value even when their exercise price is higher than or equal to the market price, because of stock volatility the market price may exceed the exercise price before the option expires.

Checklist 6
Business Appraisal Review Checklist

- ❑ Table of contents.

Appraiser's opinion letter.

- ❑ Identification of the entity being valued.
- ❑ Effective date of the valuation and issuance.
- ❑ Purpose of the appraisal.
- ❑ Standard and premise of value.
- ❑ Interest being valued.
- ❑ Valuation conclusion.
- ❑ Any report use limitations.
- ❑ Appraiser's signature.

The report body.

- ❑ Purpose of the appraisal. Usually it is for federal estate tax purposes.
- ❑ Correct fair market value definition.
- ❑ Valuation process and methodology.
- ❑ Description of process used in performing the valuation.
- ❑ Methods the appraiser selected and the reason for selecting each method.
- ❑ Optional: Methods considered and reasons for not using.
- ❑ Source for determining the key variables and data used.
  - ❑ Income tax returns.
  - ❑ Financial statements.
  - ❑ Description of the business and its history.
  - ❑ Type of business entity.
  - ❑ Type of business.
  - ❑ History.
  - ❑ Services and products.
  - ❑ Competition.
  - ❑ Location of operations.
  - ❑ Markets served.
  - ❑ Management depth.
  - ❑ Other relevant information.
- ❑ Ownership interests, restrictions, agreements.
  - ❑ Control of the business.
  - ❑ Marketability of interests.
  - ❑ Restrictions on transferability.
- ❑ Financial analysis.
  - ❑ General economic outlook.
  - ❑ Financial data relied on by appraiser.
  - ❑ Management performance.
  - ❑ Financial position.
  - ❑ Results of operation.
  - ❑ Future outlook for the industry.
  - ❑ Law or regulatory changes affecting the industry.
- ❑ Adjustments.
  - ❑ Capitalization rates used.
  - ❑ Discounts, amount and reasons.
  - ❑ Premiums, amount and reasons.
- ❑ Overall.
  - ❑ Are the conclusions sound?
  - ❑ Statement of appraiser's qualifications.
  - ❑ Appraisal was performed independently.
  - ❑ Fee is not contingent on valuation result.
  - ❑ Appraiser has no present or perspective interest in business.

[2] Market approach

This is the typical way for unrestricted options to be valued. Restricted stock options in a public company can be valued by starting with the value of unrestricted options and then addressing any decreases due to the restrictions. This approach is

impractical for closely held companies. Valuing restricted options under a market approach may require the services of an appraiser.

[3] Black-Scholes model

Black-Scholes, a commonly used pricing model, was developed and published in 1973 by Fischer Black and Myron Scholes. This mathematical model is based upon complex calculations and requires subjective judgments as to future volatility, dividend rates and lost interest. Some assumptions include (i) a stock pays no dividends during an option's life (unlikely on publicly traded stocks); (ii) exercise of an option will take place only on the expiration date (but the valuation date may not be the expiration date); (iii) markets are continuous without changes and historical information can forecast the future (contrary to post 9-11 market history); (iv) investors incur no transaction costs or commissions to buy and sell options (not a realistic assumption); and (v) investors' rates of return can be identified and are constant during the option period at a risk-free interest rate. There are software packages and web sites with simplified Black-Scholes calculators with input of the stock market price, the strike price, stock volatility (market price history or market beta), time to the option's expiration, and risk-free interest rate, which can be used for most publicly traded stocks. Options in closely held companies will probably necessitate a business appraiser to use Black-Scholes.

[4] Discounts for lack of marketability

Because of restrictions upon transferability, there should be discounts for the lack of marketability.

[5] IRS safe harbor

Rev. Proc. 98-34, 1998-1 CB 983 provides a methodology for the valuation of certain stock options for purposes of gift, estate, and generation-skipping transfer taxes. The methodology described is an option pricing model that takes into account factors similar to those established by the Financial Account Standards Board in Accounting for Stock-Based Compensation, Statement of Financial Account Standards No. 123. The methodology applies only to the valuation of nonpublicly traded stock options for stock that on the valuation date is publicly traded on an established securities market.

In Rev. Proc. 2003-68, 2003-34 IRB 398, the IRS has issued safe harbor methodology for valuing stock options, while stating that taxpayers may value stock options using methodology consistent with generally accepted accounting principles, such as SFAS 123. SFAS 123 suggests using an option pricing model with adjustment made to some of the inputs due to the non-transferability of the option. A taxpayer may value a compensatory stock option using any valuation method that is consistent with generally accepted account principles. The valuation is not considered consistent with generally accepted accounting principles unless the valuation is made in accordance with Rev. Proc. 98-34, 1998-1 CB 983, or the valuation safe harbor provided in Rev. Proc. 2003-68. The safe harbor in the revenue procedure is based on the Black-Scholes model. Two important factors under Black-Scholes are volatility and time, both handled differently under the safe harbor and SFAS 123. For stock not publicly traded and in corporations not required to register under the SEC Act of 1934 the taxpayer must assume medium volatility (annual standard deviation of returns of between 30% and 70%); for publicly traded stocks the volatility disclosed in the most recent financial statement are used. SFAS 123 recommends using long term historical volatility for publicly traded companies and non- publicly traded companies can assume volatility of zero. Under the safe harbor, the time to be used is the time remaining until expiration. SFAS 123 suggests that the time can be less than the expiration date. Because time and volatility have the most effect on option values when using Black-Scholes, and it is possible to calculate widely different option values using the various methodologies, an appraiser knowledgeable with the Black-Scholes calculations may be able to develop the most desirable value.

[E] More information

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 at 96. The benefits of not following the IRS safe-harbor valuation methods in Rev. Proc. 98-34 are discussed in Haas, "Valuation of Nonqualified Stock Options for Estate and Gift Tax Purposes," *Valuation Strategies,* July-August 2003.

§6.11 *Flower bonds*

Whatever happened to flower bonds? We no longer 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 CB 172 for the special valuation rules, and See, Rev. Proc. 69-18, 1969-2 CB 300 for redemption to pay estate tax.

§6.12 *U.S. Government debt*

It appears to the author that savings bonds are reported on Schedule B while Treasury notes and bills are reported on Schedule C, but no authority on that has been located.

US savings bonds present an interesting exception to the willing buyer-willing seller test, because savings bonds are non-negotiable and non-transferable, making them effectively non-marketable. That does not support a discount for lack of marketability. Rev.Rul. 55-278 stated that savings bonds' only ascertainable value are the amount in which they are redeemable by the United States Treasury and are includable in the gross estate at the savings bond redemption value. *See also, U.S. v. Cartwright*, 411 US 546 (1973) and TAM 200303010.

Series EE, I, E bonds can be valued by the Bureau of Public Debt at:

www.publicdebt.treas.gov/servlet/sbcy/price.

§6.13 *Collars*

There appears to be little authority on the proper method of reporting and valuing a typical over-the-counter collar on an estate tax return, but the following reporting should be in substantial compliance. Report the value of the stock and any positive value of the collar (the put) on Schedule B. Deduct the negative value of the collar (the call) either on Schedule B or on Schedule K.

§6.14 *Alternate valuation*

[A] Multiple AVDs

When a stock has two or more alternate valuation dates, list the shares of stock under one valuation date separate from the shares under the other valuation date(s).

[B] Interest and non-interest bearing obligations

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, as well as the date of death value. The regulations state that a partial payment of principal made between the date of death and the subsequent valuation date will be included in the gross estate and valued as of the date of such payment. Treas. Reg. §20.2032-1(d)(1).

The regulations also state the alternate valuation rule for non-interest bearing obligations sold at a discount such as savings bonds. Treas. Reg. §20.2032-1(d)(3). The principal obligation and the discount amortized to the date of death are property interests existing at the date of death and are included, yet the obligation itself is to be valued at the alternate valuation date without regard to any further increase in value due to amortized discount, because the additional discount amortized after death and during the alternate valuation period is the equivalent of interest accruing after death and not included in the alternate valuation date value.

[C] Dividends

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, as well as the date of death 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. Treas. Reg. §20.2031-1(d)(4).

[D] Stock in reorganization or liquidation

According to the regulations, the phrase "distributed, sold, exchanged, or otherwise disposed of" includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to IRC § 331, but does not include "transactions which are mere changes in form" such as a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under IRC § 351. The phrase also does not include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction, such as a merger, recapitalization, reorganization or other transaction described in IRC § 368(a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under IRC § 354 or 355. Treas. Reg. §20.2032-1(c)(1).

[E] Stock distribution date

Date of distribution may not be clear in a particular instance which cautions that any dealing with the stock needs to be handled with the thought in mind that it may be a distribution that fixes the alternate valuation date. In the Ninth Circuit that date of distribution was the date on which the executor was authorized by a state probate court order to distribute capital stock to the residuary legatees, rather than the date on which the stock was actually delivered to them. *J.C. Hertsche, Jr., Exr. v. U.S.*, (DC Ore.) 65-2 USTC ¶ 12,325, 244 F. Supp. 347, *aff'd* 66-2 USTC ¶ 12,12,424, 366 F.2d 93 (9th Cir. 1966). In the Eighth Circuit for purposes of fixing the alternate valuation date, the distribution of shares of stock to the remaindermen of a trust established by a decedent during her lifetime occurred when the shares were transferred on the books of the corporation. *Estate of M.M. Sawade*, 86-2 USTC ¶ 13,672 (8th Cir. 1986).

§6.15 *Attachments*

The following documents should be included as attachments:

(1) Copies of quotations from brokers. Instructions, p. 13.

(2) Copies of valuations of publicly traded securities. Suggestion: If your report includes a security that subsequent investigation reveals the decedent did not own, or if the valuation report contains an incorrect value (yes, on occasion it does happen), pay the extra for a clean and correct report to avoid expensive explanations to the IRS upon audit.

(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. 13.

(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 to 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. 13. If reporting more than a few closely held businesses and this information is quite voluminous, consider not attaching this information and say that the detailed information is available upon request.

(7) Copies of correspondence or statements used to determine that securities are of no value. Instructions, p. 13.

§6.16 *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).SCHEDULE C - Mortgages, Notes and Cash

§6.17 *When completed*

According to the Instructions, 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.

[A] Jointly held

Jointly held mortgages, notes and cash are properly reported on Schedule E. Form, Schedule C, p. 13.

[B] 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.

[C] Subject to power of appointment

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

[D] 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. Form, Schedule F, p.20.

§6.18 *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.

When items d and e combined are less than the debts, taxes and expenses of administration, then one may deduct the expenses of sale.

§6.19 *Mortgages and promissory notes*

[A] Payable to decedent

Mortgages and notes payable to the decedent are assets listed on Schedule C, and mortgages and notes the decedent owes are listed on Schedule K. Form, Schedule C, p. 14.

[B] 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." The instructions give this sample entry:

> Example to enter in "Description" column: "Bond and mortgage of $50,000, unpaid balance: $24,000; dated: January 1, 1983; John Doe to Richard Roe; premises: 22 Clinton Street, Newark, NJ; due: January 1, 2001; interest payable at 10% a year--January 1 and July 1."

[C] Valuation of mortgages and notes

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.

Rev. Rul. 67-276, 1967-2 CB 321, addressed the evidence that must be furnished by an estate for consideration by the Service in determining the value of mortgages and mortgage participation certificates. The ruling stated that the presumption that their face value is their true value governs unless the representative of the estate submits convincing evidence to the contrary, and value is a question of fact and the burden of proof is on the estate to overcome the presumption. Pertinent factors to be considered in determining value "include the valuation of real estate and any collateral covered by the mortgages, arrears in taxes and interest, gross and net rentals, foreclosure proceedings, assignment of rents, prior liens or encumbrances, present interest yield, over-the-counter sales, bid and asked quotations, and etc." Incredibly, values from an established market may not be conclusive, according to the ruling. "The existence of an over-the-counter market for such securities and the quotations and opinions of value furnished by brokers and real estate appraisers cannot be accepted as conclusive evidence of the value of such securities. Such sales and bid and asked quotations are merely items to be considered with other evidence in fixing values." Mortgages amply secured, determined by valuing the property securing the mortgage upon the same factors are used in fixing the valuation of real estate owned in fee, will be valued at face value plus accrued interest to the date of death." But, where the security is insufficient, "the mortgage will be valued upon the basis of the fair market value of the property less back taxes, estimated foreclosure expenses, and where justified, the expense of rehabilitation." Where the mortgage is not affected by moratorium laws, the mortgagee's recourse against the mortgagor personally will be taken into consideration. The ruling suggests that where the security is sufficient, the mortgage is valued at face value. In PLR 8229001, the Service commented that the proper way to value notes and mortgages is to consider all available financial data and all relevant factors affecting the fair market value. One factor alone, such as collateral, is insufficient to set a proper value on a mortgage. The Service stated that the revenue ruling implicitly assumes that at the date of death or alternate valuation date that the mortgage will bear an adequate interest rate that is approximately the current interest rate. The rate of return and the length of time to maturity are important factors. "When interest rates increase, the effective rate of return on existing debt obligations correspondingly decreases. Thus, the existing obligations decrease in value because their effective rate of return will be less than the rate of return on just-issued debt obligations bearing interest at the now higher rate of interest." *Id.*

[1] Value at moment of death

For an interesting ruling that deals with the issue of whether the moment of valuation immediately precedes the moment of death or after, see TAM 9240003. A note payable by the decedent's insolvent nephew (with assets of $39,200) was valued at substantially less than the balance of $455,000. The IRS agreed that the appropriate value of the note was not after the moment of death. With the bequest of the note and $1,000,000 to the nephew, he was solvent immediately after the moment of death. This TAM appears to be consistent with *McClatchy v. Comm.*, discussed in § 6.03[D].

[2] 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 to the recipient as ordinary income.

[3] Self-canceling installment notes

Self-canceling installment notes (SCINS) raise an interesting question of whether they need to be reported on the return. The argument that they do not is that if done right, they are not properly included in the estate. Yet, disclosure of the existence of the SCIN, even if no value is included, may go far in avoiding an understatement of value penalty or in showing overall good faith in filing the return when other difficult issues are present and may surface.

Estate of Musgrove v. U.S., 33 Fed. Cl. 657;95-2 U.S.TC ¶ 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.

Estate of Costanza v. Comm., 320 F.3d 595 (6th Cir. 2003), *rev'g and remanding* TC Memo 2001-128, blessed the use of self-canceling installment notes (SCINs) as a valid estate planning tool. The Sixth Circuit opinion accepted a planning technique approved in *Estate of Moss v. Comm.*, 74 TC 1239 (1980), but left the valuation of the note an open issue.

[4] Installment gain

If decedent reported the note on the installment gain method for federal income tax purposes, upon decedent's death, there is no step-up in basis. The unreported gain is income in respect of a decedent. Unless the estate disposes of the note and causes the gain to be taxed to the estate, the recipient of the remaining note payments will report the gain. IRC §s 691(a) and 1014(c).

[5] Full and adequate consideration

Taking a valuation discount on a note may be inconsistent with the decedent having received full and adequate consideration in the transaction giving rise to the note. Notes discounted at death probably should have been discounted when received. If the decedent received notes in a sale to a family member, and they properly should have been discounted, then the decedent may not have received full and adequate consideration and the transaction was part sale, part gift. The preparer and executor will be obligated to report that gift as part of preparing the estate tax return.

[D] Gift loans

IRC § 7872 provides for special tax, including estate tax, treatment of certain below-market loans, including "gift loans," defined as "any below-market loan where the forgoing of interest is in the nature of a gift." IRC § 7872(f)(3). A "below-market loan" is either a demand loan on which interest is payable on the loan at a rate less than the applicable federal rate, or a term loan on which the amount loaned exceeds the present value of all payments due under the loan. IRC § 7872(e)(1). "Forgoing of interest" is not defined, but "forgone interest" is defined with respect to any period during which the loan is outstanding as the excess of the amount of interest that would have been payable on the loan for the period if interest accrued on the loan at the applicable federal rate and were payable on the last day of the calendar year over any interest payable on the loan properly allocable to such period. IRC § 7872(e)(2). Proposed regulations were issued as to the estate tax consequence of gift loans in August 1985, and they remain proposed and are not yet final regulations. The estate and the preparer cannot rely on the proposed regulations but they must disclose on the return if a position is taken contrary to the regulations. The proposed regulations would amend Treas. Reg. §20.2031-4 to add the sentence: "See Treas. Reg. §20.7872-1 for special rules in the case of gift loans (within the meaning of §1.7872-4(b)) made after June 6, 1984." Proposed Treas. Reg.§20.7872-1, which applies with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement and regardless of whether that interest rate exceeds the applicable federal rate in effect on the day on which the loan was made, states:

> [A] gift term loan (within the meaning of §1.7872-4(b)) that is made after June 6, 1984, shall be valued at the lesser of:
>
> (i) the unpaid stated principal, plus accrued interest; or
>
> (ii) the sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.

A term loan could be valued less than the value of its stated principal and under clause (ii) where the stated interest rate is less than the applicable federal rate. A "gift term loan" is not defined in §1.7872-4(b), which is also proposed, but the provision states, "The term 'gift loan' means any below-market loan in which the foregoing of interest is in the nature of a gift within the meaning of Chapter 12 of the Internal Revenue Code (whether or not the lender is a natural person)." The referenced proposed regulation adds nothing to the code definition, particularly in the estate context in which a lender will always be a natural person. As a trade-off to using the present value using the applicable federal rate discounts will be permitted only if there is a significant change in the facts related to collecting the loan, such as a decrease in financial condition of

the borrower. Proposed Treas. Reg §20.7872-1 states, "No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectibility of the loan have changed significantly since the time the loan was made." No discount would be permitted for lack of marketability simply because the borrower is an individual, because that fact would not have changed.

The question is whether the proposed Section 7872 regulations must be used to value a gift loan? It would seem that the estate may wish in valuing a loan to take a lack of marketability discount that may be greater than the combined discounts from using the applicable federal rate and changed facts that post date the making of the loan. Because the proposed regulations appear to be mandatory, to use a different valuation method and make no disclosure on the estate tax return of not following the IRC § 7872 proposed regulations, one must first find that the loan is not a gift loan because it was not made with donative intent.

[E] Accrued interest

Accrued and unpaid interest is to be separately listed, Treas. Reg. §20.2031-4, and included in the gross estate. It represents income in respect of a decedent.

[F] Alternate valuation date

Generally, 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. The regulations provide that any partial payment of principal made between the date of death and the alternate valuation date and any advance payment of interest for a period after the valuation date made during the alternate valuation period that has the effect of reducing the value of the principal obligation as of the alternate valuation date will be included in the gross estate and valued as of the date of the payment. Treas. Reg. §20.2032-1(d)(1).

§6.20 *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 payments; unpaid balance of principal; and interest rate." Form, p. 14. The regulations also require the accrued interest and the date prior to decedent's death to which interest had been paid. Treas. Reg. §20.6018-3(c)(2).

[A] 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.

[B] 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. Comm.*, 69 TC 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).

[C] Non-binding contracts

Non-binding contracts to sell real property should not be listed on Schedule C, but rather should be listed on Schedule A.

§6.21 *Cash in possession*

[A] Cash on hand

The instructions require that cash on hand be listed separately from bank deposits. Form, Schedule C, 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." Treas. Reg. §20.6018-3(c)(3). Cash on hand would include cash normally carried on the person, cash in home safes, and cash kept in safe deposit boxes. See the discussion of the criminal failure to report cash on hand in §1.15[E].

On remand from the Ninth Circuit, the Tax Court in *Trompeter v. Commissioner*, TC Memo. 2004-27; No. 11170-95, set forth its finding as to unreported cash on hand.

> The coexecutors reported on the estate's Federal estate tax return that all of his money (exclusive of coin collections) as of the applicable valuation date was held in financial institutions. The coexecutors did not report any cash that the decedent has at home. The decedent kept cash at home in a burlap bag secured in a large safe in his den, and he routinely went to the safe when he needed money to spend. The decedent was very private about the contents of his safe, and he generally did not tell his closest friends about its existence, nor allow them to enter the den.
>
> A few days before the decedent died, he gave the combination to his home safe to Polachek and taught her how to open the safe by

herself. Polachek testified that the safe had cash in it at this time but that it had not cash in it when she and Gonzalez opened the safe together following the decedent's death. Gonzalez was regularly in the decedent's home following his death, including the period of time before she and Polachek opened the safe together. Gonzelez testified to the effect that she did not know how to open the safe alone, but needed Polachek's assistance to do so. We find that testimony incredible. Gonzalez was deeply involved with the decedent and his wealth for approximately 1 year before his death, and we believe it incredible that the decedent would have taught Polachek to open the safe but not Gonzalez. This is especially so given the fact that the decedent informed Gonzales as to the specifics of his extensive holdings.

We find that the decedent when he died had cash of $50,000 at home. The decedent when he died had amassed at his home valuable assets worth hundreds of thousands of dollars, and we believe under the facts and circumstances of this case that it is reasonable to conclude that the decedent also kept at home a significant amount of cash. This is especially so given that the decedent tended to keep his assets secreted at home rather than in banks (e.g., he kept many of his coins hidden in his garage) and that he had a history of giving large sums of cash (not checks) to at least Gonzalez, Polachek, and Wong. He gave $16,000 in cash to Wong in or about 1987. He gave $50,000 in cash to Gonzalez and Polachek in 1991. He gave to Wong in or about 1991 cash of $77,000 and additional money to pay off approximately $250,000 of her debts. We also note that some of the receipts in evidence do not relate to the decedent's checks in evidence, which indicates to us that the decedent on various occasions paid large sums of cash for his purchases of the items which he collected.

[B] 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.

§6.22 *Cash in banks and other financial institutions*

The instructions require that bank accounts be listed separately from other cash. Form, p. 14.

> A description of bank accounts shall disclose the name and address of depository, amount on deposit, whether a checking, savings, or a time-deposit account, rate of interest, if any payable, amount of interest accrued and payable, and serial number. Treas. Reg. § 20.6018-3 (c)(3).

Instructions to Schedule C, Form, p. 14, do not request the rate of interest and clarifies that by the serial number they mean the account number.

[A] 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 regulations also request the interest rate. Treas. Reg. §20.6018-3(c)(3).

[B] 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 includable 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.

[C] Outstanding gift checks

[1] 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. Comm.*, 83 TC 227 (1984).

[2] 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 CB 351; *Estate of Joseph Gagliardi v. Comm.*, 89 TC 1207 (1987). The same conclusion was reached by the Tax Court in *Estate of Newman*, 111 TC 81 (1998), where decedent's son had written $95,000 of checks under a durable power of attorney shortly before her death.

A circuit court has sided with the IRS that the "relation back" doctrine is not applicable in the case

of non-charitable gifts. *Rosono v. U.S.*, 245 F.3d 212 (2d Cir. 2001).

This rule for personal checks would not apply apparently to cashier's checks, certified checks, or money orders, provided there is actual delivery of the instrument prior to death. The ability to revoke the instrument remains while the cashier's check, certified check or money order is in the possession of the payor or maker, but becomes irrevocable upon physical delivery of such check or money order. There are no cases dealing with this, however, the conclusions seem reasonable under the rules applicable to commercial instruments.

[3] Gift checks under power of attorney

For Schedule G in the section entitled "Revocable transfers, IRC § 2038" inclusion in the estate of gift checks made pursuant to powers of attorney is discussed.

[D] 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.

[E] Alternate valuation

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

[F] 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] Checks, unnegotiated

Unnegotiated checks on which the decedent is the payee, not the payor, are not properly listed on Schedule C. See the discussion for "Checks, Unnegotiated," under Schedule F.

§6.23 *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. Fluctuations in exchange rates on the valuation date apparently can be resolved in favor of the estate: the mean between the high and the low, the opening rate or the closing rate. The alternate valuation date value for foreign currency can be different than the date of death value due to fluctuations in exchange rates. Historical currency exchange rates can be found at http://www.oanda.com/convert/fxhistory.

§6.24 *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 to be 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. They are to be retained for IRS inspection. Form, p. 14.

§6.25 *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).

[A] Preparer review

Because items may be requested upon audit, the preparer should request and review these items as part of preparing the return. Look for undisclosed gifts and undisclosed assets.

In *Trompeter v. Comm.*, TC Memo 1998-35, the Tax Court agreed with the IRS that fraud was seen from the executor's failure to initially provide the IRS with all of the decedent's canceled checks that evidenced the purchase of jewelry, gems, art and other artifacts. This failure to cooperate was a factor evidencing fraud. On remand back to the Tax Court from the Ninth Circuit, the Tax Court found the existence as well as the value of omitted assets was substantiated by among other evidence, cancelled checks relating to purchases made by the decedent. *E. Trompeter Est.*, TC ¶ 45,198 (M).

7 SCHEDULE D - INSURANCE ON THE DECEDENT'S LIFE

§7.01 *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. Form, Schedule D, p. 16. For each policy, list the name of the insurance company, the policy number, name of beneficiary, and the amount of proceeds. Form, p. 16. Treas. Reg. § 20.6018-3 (c) (4). If part or all of the proceeds are not included in the gross estate, you must explain why they were not included. Form. p. 16. These are sample explanations:

"Decedent was not the owner of the policy and held no incidents of ownership; not included in Decedent's estate. Owned by Sample Trust of 1992, reported on Schedule G."

"Community property; Decedent owned an undivided one-half interest."

[A] 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.

[B] Locating life insurance policies

While numerous life insurance companies sell life insurance policies, unfortunately no single source exists to which one can inquire as to the existence of life insurance on an individual's life. Short of asking all insurance companies, these steps will provide reasonable assurance of locating all life insurance.

(i) Review decedent's cancelled checks for premium payments.

(ii) Check decedent's mail. Insurance companies are required to report the status of life insurance policies at least annually. Decedent's policy will become known when the annual statement arrives in the mail.

(iii) Contact the Medical Information Bureau for a copy of decedent's file. During the underwriting process on larger policies, the insurance company will contact the bureau.

(iv) Contact the decedent's physicians. Even on smaller policies an insurance company will request a copy of the decedent's medical records and a copy of the "attending physician's statement" will probably be retained in the file.

[C] 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; Treas. Reg. §20.6018-4(d). The Form says to attach the Form 712 to the back of Schedule D, but the important thing is that it be an attachment to the return regardless of whether it is actually attached to Schedule D.

[1] If Form 712 not available

It may be impossible to get a Form 712 on some types of insurance. For example, the Veterans Administration may 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. When making and using a copy of the check itself, clearly indicate by stamp or by large block letters that it is a "COPY."

[2] 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. Apparently, this requirement also applies when the policy was gifted by the insured. That gift would not appear on the application but by the document of transfer of ownership, which need not be attached.

[3] Revised Form 712

A revised Form 712, Life Insurance Statement (Rev. May 2000) has been released, containing three additional questions regarding (1) whether the policy was transferred within three years prior to the death of the decedent, (2) the date of the transfer, and (3) whether the decedent had any incidents of ownership on any policies on his or her life that were not owned by the decedent at the date of death.

[D] 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, Schedule D, p. 16.

[1] 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.

[2] 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.

[3] Unearned premiums

Unearned or refunded premiums are included in the gross estate. Generally, premiums are payable in advance and are *earned* as time proceeds. Premiums are not earned when death occurs before the next premium is due.

[4] Value when litigation pending

When litigation to collect the proceeds is pending at the time the estate tax return is to be filed, the value is the fair market value at the date of death, according to PLR 8308001, rather than the amount of the settlement received by the estate after the lawsuit was filed or the amount of the proceeds fully payable. To your author, if this ruling is read as the estate tax return amount being the proceeds payable if paid in full discounted by the uncertainty of collection, then the ruling is correct. If more proceeds are ultimately collected than what is reported, that difference should neither be subject to federal estate tax nor income tax.

[E] Alternate valuation

For proceeds received as a lump sum, the same amount is listed for DOD and AVD values. Rev. Rul. 58-576, 1958-2 CB 625. 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. 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.

§7.02 *Insurance included in the gross estate*

[A] When included

Under IRC § 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.

[B] For benefit 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. Treas. Reg. §20.2042-1(b) sets forth what is meant by "receivable by the executor" under IRC § 2042(1):

> Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includable in the gross estate.

The instructions further elaborate.

> 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, Schedule D, p. 16.

The last sentence of the Instructions is only in the Instructions and your author has been unable to find any other support.

If a life insurance policy is held by an irrevocable life insurance trust, and the trustee is *directed* to pay the debts, administration expenses or estate taxes of the decedent's estate, even if the trustee pays those items independent from the executor, the amount the trustee is obligated to pay is included in the decedent's estate and listed on Schedule D. When insurance is payable to a trustee and the latter is *authorized but not directed* or required to transfer the proceeds to the executor for payment of estate expenses, the proceeds are excluded from the insured's gross estate. *Old Colony Trust Co. v. Commissioner*, 39 BTA 871 (1939), acq. 1939-2 CB 27. For a ruling where the trustee of the trust was authorized it its sole discretion to pay debts or liabilities of any kind of the joint insureds and pay the estate tax, inheritance tax, or any other tax or expense due by reason of the insureds' deaths, but was under no compulsion to do so, and the IRS ruled that proceeds were not included in the estate of an insured, see PLR200147039. But, there is authority for the proposition that if in fact funds are used to pay estate obligations, they are included in

the gross estate. *Estate of Salisburg v. Commissioner*, 34 TCM 1441 (1975).

Treas. Reg. §20.2042-1(b) also states that if the decedent purchases an insurance policy in favor of another person or corporation as collateral security for a loan or other accommodation, the policy proceeds are considered to be receivable for the benefit of the estate, with the loan as a deduction. This result was approved in *Bintliff v. U.S.*, 402 F.2d 403 (5th Cir. 1972).

There are two interesting revenue rulings with regard to payments of proceeds to testamentary trusts. Rev. Rul. 73-404, 1973-2 CB 319, addressed payments from a qualified profit sharing plan to a testamentary trust, and held they were not "receivable by or for the benefit of the decedent's estate" and therefore excludible. While the ruling was based in part on IRC § 2039(c), now repealed, the holding should still be good law. The ruling further indicated that the same result would apply: (i) with respect to an inter vivos trust and (ii) if state law instead of the will prohibited use of funds for any of the purposes causing inclusion. As to the latter point on state law providing the prohibition, that was ruled in Rev. Rul. 77-157, 1977-1 CB 279.

[1] 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. Discussed below, in "Community property policies."

[2] 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.

[a] 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

[b] 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.

[3] When payable to the estate

Proceeds will be payable to the estate:

[a] Where the estate is designated as the primary beneficiary.

[b] The estate is designated as the secondary beneficiary or contingent beneficiary and the primary beneficiary is not paid.

[c] 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.

[d] 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. Inclusion in the estate by operation of law was found in *Estate of Prautt v. Commissioner*, 125 F.2d 591 (6th Cir. 1942); *Commissioner v. Jones*, 62 F.2d 496 (6th Cir. 1932); *Webster v. Commissioner*, 120 F.2d 514 (5th Cir. 1941).

Check the policy and the beneficiary designation to confirm that the Form 712 lists the proper beneficiary. Sometimes the Form 712 does not show the correct ownership and it is up to the preparer to confirm that the Form 712 is correct.

[4] Payable to decedent's revocable trust

Margrave v. Comm., 618 F.2d 34 (8th Cir. 1980), gives what at first blush may seem to be a surprising result for insurance proceeds on a policy on decedent's life owned by decedent's wife, but on which she named as the beneficiary the trustee of the decedent's revocable trust. Upon decedent's death the proceeds were not returned as part of decedent's gross estate and upon audit the Service assessed a deficiency. The Tax Court held that decedent possessed no "incidents of ownership" and "no power of appointment" over the policy or proceeds and the Eighth Circuit affirmed, stating

> [T]here was never an instant when Mr. Margrave possessed more than a mere power over an expectancy. During his life, decedent's power was subject to the absolute whim of Mrs. Margrave who could completely eliminate decedent's ability to designate the beneficiary through her own power to modify or revoke the insurance policy. At his death, [decedent's] power to designate the beneficiary, by the terms of the trust, ceased to exist. In such circumstances we are unable to find "incidents of ownership" sufficient to include the proceeds of the insurance policy in decedent's gross estate under [IRC §] 2042(2). *Id*. at 37-38.

In Rev. Rul. 81-166, 1981-1 CB 477, the Service stated that under similar circumstances the Service will no longer advance the position that the insurance proceeds are includible in the insured's gross estate under IRC §s 2041 or 2042.

[C] 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, Schedule D, p. 16.

[1] "Incidents of ownership" defined

According to the regulations, "[T]he term "incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Treas. Reg. §20.2042-1(c)(2). "[T]he very phrase 'incidents of ownership' connotes something partial, minor, or even fractional in its scope. It speaks more of possibility than of probability." *U.S. v. Rhode Island Hospital Trust Co.*, 355 F.2d 7 (1st Cir. 1966). 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.* Rev. Rul. 75-70, 1975-1 CB 301 addressed a situation where a decedent had assigned all of his right, title and interest in an insurance policy on his life to his wife as owner and beneficiary, but retained the power to prevent the change of beneficiary to, or assignment of, the policy to anyone not having an insurable interest in his life without his consent. The ruling said that there is little practical difference between the power to consent to or veto the exercise of an incident of ownership by another and the power to initiate such exercise unilaterally. The decedent had effectively retained substantial control over some of the incidents of ownership and the policy proceeds were included in his estate. The ruling cited *Goldsteins Estate v. U.S.*, 122 F. Supp. 677(1954) and *Karaheusian v. Commissioner*, 233 F.2d 197(2d Cir. 1956).

(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. 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). 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).

(9) *The retention of control over the cash value of split dollar insurance*. Treas. Reg. §§20.2042-1(c)(2),(3),(4) and(5).

(10) *The right to borrow held by a controlled corporation.* Rev. Rul. 82-145, 1982-2 CB 213.

(11) *A contingent purchase option*. Rev. Rul. 79-46, 1979-1 CB 303; *contra, Estate of John Smith v. Commissioner*, 73 TC 307(1979) acq. In result only, 1981-1 CB 2.

(12) *An insured's right to consent to a change of beneficiary on a split dollar policy owned by his employer*. *Schwager v. Commissioner*, 64 TC 781(1975).

(13) *A retained purchase option may be an incident of ownership*, T.A.M. 9128008; but a right to purchase the policy itself may not, as ruled in PLR 9233006.

State law will determine whether a decedent held such incidents of ownership. *Estate of Levy v. Comm.*, 70 TC 873 (1978) gives a history of how "incidents of ownership" came into the statute, of the committee reports that accompanied the statute, and of the regulations that denote the meaning of the term.

In *Estate of Anders Jordhal*, 65 TC 92 (1975), acq. 1977-1 CB 1, the Tax Court held that the power to substitute assets of equivalent value was not an incident of ownership for purposes of IRC § 2042(2).

[2] 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. In Rev. Rul. 84-179, 1984-2 CB 195, the decedent transferred a life insurance policy on his life to decedent's spouse and subsequently, on the spouse's death, reacquired incidents of

ownership over the policy as the trustee of a testamentary trust established by the spouse. This revenue ruling held that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of IRC § 2042(2), provided that the decedent did not furnish any consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The ruling further held that the result would be the same if the decedent, acting as trustee, purchased a policy as a trust asset, did not contribute assets to the trust or maintain the policy with personal assets and could not exercise the powers for personal benefit. Yet, according to the ruling, where the decedent's powers over the policy could have been exercised for the decedent's benefit, the decedent would be treated as possessing incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums.

This revenue ruling was followed in PLR200404013 where one spouse created an irrevocable trust of which the other spouse and a corporate trustee were co-trustees with absolute discretion to distribute income and corpus to the grantor spouse's children and descendents. The trust purchased a joint and survivor life insurance policy on the lives of the spouses with funds contributed by the grantor spouse but an election was made by the spouse trustee to gift split. The spouse trustee executed a written instrument renouncing the right as trustee to: (1) change the beneficiary of the policy, (2) revoke any change of beneficiary, (3) assign the policy, and (4) revoke any assignment of the policy, and as spouse any right to make contributions to the trust and to appoint a successor advisor. The ruling noted that the trust purchased and owns the life insurance policy, is the designated beneficiary of the policy proceeds and will make all future premium payments from trust assets. Because it was represented that the spouse trustee has not transferred any property to the trust, nor will the spouse trustee make any transfers to the trust in the future to maintain the policy, the ruling concluded that the spouse trustee will not possess any incidents of ownership and the policies will not by includable in the spouse-trustee's estate.

In *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), the decedent served as trustee of three irrevocable trusts created by the decedent's brother for the benefit of decedent's three children. The decedent as trustee of each trust applied for three separate life insurance policies on his own life. Decedent as trustee was made the owner and trustee of each policy. The district court found the decedent-trustee possessed the right and power to alter the time and manner of enjoyment of the policy proceeds through his authority to withdraw dividends, obtain loans, or cancel or convert the policies. The appeals court concluded that the decedent possessed incidents of ownership in the insurance policies on his life that he held as trustee.

Terriberry v. U.S., 517 F.2d 286 (5th Cir. 1975), involved an instance of decedent's wife creating a revocable trust of which decedent was trustee and to which she transferred seven life insurance policies on the decedent's life. The trust agreement expressly prohibited the decedent as trustee from exercising any of the incidents of ownership.

[3] Group term policies

As to the power to cancel or surrender a policy being an incident of ownership, if the insured under a group term policy has transferred the policy to an irrevocable life insurance trust, the insured may effectively cancel the group term policy by terminating the insured's current employment. The IRS has ruled, Rev. Rul. 72-307, 1972-1 CB 307, that such possibility is not an incident of ownership.

[4] Decedent held policy as custodian or trustee

The situation may arise in which the decedent holds a policy on his or her own life as custodian for a minor under the Uniform Transfers to Minors Act. Section 13 of the Act, entitled "Powers of Custodian" states,

> (a) A custodian, acting in a custodial capacity, has all the rights, powers, and authority over custodial property that unmarried adult owners have over their own property, but a custodian may exercise those rights, powers, and authority in that capacity only.

The Comment to this provision explains that this language is designed to prevent the custodian from holding an incident of ownership on a life insurance policy on the custodian's life.

> Subsection (a) further specifies that the custodian's powers or incidents of ownership in custodial property such as insurance policies may be exercised only in his capacity as custodian. This provision is intended to prevent the exercise of these powers for the direct or indirect benefit of the custodian, so as to avoid as nearly as possible the result that a custodian who dies while holding an insurance policy on his own life for the benefit of a minor will have the policy taxed in his estate. See, Section 2042, I.R.C.; but compare *Terriberry v. U.S.*, 517 F.2d 286 (5th Cir. 1975), and *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975).

In the two cases cited in the Comment, incidents of ownership held by the insured in his capacity as

trustee nevertheless required inclusion in his estate under IRC § 2042(2).

§7.03 *Policies held by a corporation*

[A] 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). It was held in *Estate of John L. Huntsman*, 66 TC 861 (1976), that insurance proceeds are not simply added to the value of the stocks, but rather are treated as one of the non-operating assets to be considered in the stock's valuation, when the corporation holds all incidents of ownership and the proceeds are payable to the corporation, because the insurance is owned by the corporation. In this case, the decedent-insured was sole stockholder, president and treasurer. Incredibly, the IRS argued that prorating the proceeds over the shares and adding that to the value of the stock as otherwise determined, was consistent with the Treas. Reg.§ 20.2031-2(f).

[B] Proceeds paid to the corporation become IRD

Estate of Robert E. Cartright v. Comm., TC Memo 1996-286, addressed the correct characterization of proceeds under life insurance policies on the life of a majority shareholder in a law firm. Under an amended shareholder's agreement, the law firms payment to decedent's estate was found to be partly for decedent's stock and partly for claims for work in process. The stocks received a step-up in basis upon death and the payment to the estate did not create taxable income, but the payment for work in process was held to be IRD that needed to be reported as income on the estate's income tax return.

[C] 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. Treas. Reg. § 20.2031-2 (f). *Estate of Levy v. Comm.*, 70 TC 873 (1978), addressed the validity of these regulations in application to a controlling shareholder. The portion of split dollar life insurance proceeds that were payable to the insured decedent's widow as beneficiary was held to be includable in the decedent's gross estate, since decedent owned 80.4% of the voting stock of the corporation that held the incidents of ownership in the policy. The attribution of corporate incidents of ownership applied to a controlling shareholder as well as a sole stockholder, because a controlling stockholder can also indirectly exercise the incidents of ownership through his power to elect a board of directors who would appoint obedient corporate officers. The Tax Court stated that clearly Congress did not intend to attribute corporate incidents of ownership to a sole stockholder while excluding a stockholder owning 99 percent of the voting stock of a corporation. Further, the decedent did not hold the incidents of ownership in a fiduciary capacity.

[D] 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.

§7.04 *Policies held by a partnership*

For life insurance policies held by a partnership, whether the proceeds will be included in the estate of the partner insured will depend on whether the proceeds are paid to the partnership or to a third party.

In *Estate of Knipp v. Comm.*, 25 TC 153 (1955), acq. in result, 1959-1 CB 4, aff'd on another issue, 244 F.2d 436 (4th Cir. 1957), cert. denied, 355 U.S. 827 (1957) a partnership owned 10 life insurance policies on the life of the 50% general partner. The partnership paid the premiums on all of the policies, and the insurance proceeds were payable to the partnership on the partner's death. The court found that the partnership purchased the policies in the ordinary course of business. The court held that the decedent in his individual capacity had no incidents of ownership in the policies and therefore the policies were not includible in the decedent's gross estate under the predecessor to IRC § 2042(2). The proceeds would be considered in valuation of the decedent's interest in the partnership.

Rev. Rul. 83-147, 1983-2 CB 158, addressed whether incidents of ownership in an insurance policy owned by a general partnership would be attributed to the insured general partner where a general partnership obtained a whole life insurance

policy on the life of one of its partners and the insured partner's child was designed as the beneficiary and received the proceeds upon the death of the insured partner. The partnership made the premium payments in partial satisfaction of the insured partner's distributive share of partnership income. In contrast to *Knipp* where the partnership purchased the policies in the ordinary course of business, here the proceeds were payable to a third party for a purpose unrelated to the general partnership business. The ruling also found significance in the fact that *Knipp* avoided double taxation of a substantial portion of the proceeds because the proceeds were included in the value of the decedent's partnership interest whereas here the proceeds were not included the value of the partnership interest.

In PLR 200111038 proceeds on life insurance policy on a partner were not includible in the partner's gross estate where the partnership agreement by restricting the partner's ability to participate in the partnership's daily business or exercise control over its management and investment decisions, showed that the insured possessed no incidents of ownership. In PLR 200214028 life insurance policies on the decedent's life held by and payable to a partnership under terms of a partnership agreement to facilitate buy-out of the decedent's interest without liquidation of the partnership were ruled to be not includible in the decedent's gross estate.

§7.05 *Community property policies*

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). In *W. Burris Estate*, 82 TCM 400, TC Memo 2001-210, the Tax Court held that only one-half of the proceeds of three life insurance policies on a decedent's life was includable in the decedent's gross estate because under Louisiana community property law, the decedent possessed incidents of ownership in only one-half of the policies. In Rev.Rul. 2003-40, 2003-17 IRB 813, released simultaneously with an acquiescence, in which the IRS announced that it was acquiescing in the result only, the IRS released a set of circumstances under which one-half of the proceeds of a life insurance policy will be includable in the gross estate of a Louisiana decedent, including that where a Louisiana decedent purchased a policy on his life during marriage names himself as the owner of the policy, and does not transfer ownership of the policy the policy will be presumed to be community property and as a result one-half of the policy proceeds will be includable in the decedent's gross estate. Further, if the decedent's spouse predeceases the decedent, one-half of the value of the policy is includable in the spouse's gross estate.

It was believed that the non-insured surviving spouse's community property interest is not included in the insured's estate, even if the entire proceeds are payable to the decedent's estate. However, in *Estate of Street v. Comm.*, 152 F.3d 482, 484-485 (5th Cir. 1998), the Fifth Circuit held that the estate included the entire interest where the entire amount was paid to the probate estate.

When not payable entirely to the decedent's probate estate, the spouse's interest is not included even if the policy was the decedent's sole management community property and the decedent alone could change the beneficiary. Treas. Reg. §20.2042-1(c)(5).

The *Cavenaugh* case is an interesting application of this rule where the non-insured spouse predeceased the insured. In *Estate of Cavenaugh v. Comm.*, 51 F.3d 597, 602 (5th Cir. 1995), Fifth Circuit 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 Fifth Circuit 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 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 § 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.

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.

What happens if the community property policy on decedent's life is made payable to decedent's child? Decedent's one-half interest is clearly included in the estate and will be subject to estate tax. The surviving spouse has made a taxable gift to the child effective as of the date of decedent's death. When the owner is not the decedent-insured and the owner and the beneficiary are not exactly the same, when the insured dies, the owner has made a gift to the beneficiary.

§7.06 *Simultaneous death*

[A] Community property

For a discussion of the community property aspects of life insurance where there is simultaneous death of husband and wife, s*ee*, Clary and Anderson, *Anticipating the Possibility of Simultaneous Deaths in Light of Uniform Acts Presumptions*, ESTATE PLANNING, Sept. Oct. 1987, 280.

[B] 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 CB 272; *Chown's Estate v. Comm.*, 428 F.2d 1395, 1397 (9th Cir. 1970).

§7.07 *Insurance otherwise included*

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

(a) Transfers within three years of death, Section 2035.

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

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

(d) Revocable transfers, Section 2038.

Transfers listed above are more fully discussed in Chapter 11, "Schedule G, Transfers During Decedent's Life." Such insurance is properly reported on Schedule G, in addition to Schedule D, but its value is not included twice.

§7.08 *Insurance on life of another*

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

§7.09 *Irrevocable life insurance trusts*

[A] 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. Under this argument, the policies would be listed on Schedule D, but the value is listed as zero.

[B] Purchase within three years

If the policy was acquired within three years of death and the insured held no incidents of ownership (*e.g.* 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. Comm.*, 89 TC 235 (1987), *aff'd.* 893 F.2d 237 (10th Cir. 1989). This applies even if the insured paid the premiums. *Estate of Perry v. Comm.*, 927 F.2d 209, 211-213 (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.

[C] Policies transferred within three years

If the policy is transferred to the life insurance trust within three years of death, the value of the proceeds are included in the gross estate. Transfers of insurance within three years of death are discussed in Chapter 11, "Schedule G, Transfers During Decedent's Life." If the trust holds assets in addition to a policy transferred within three years, such as would be the case if cash was transferred to continue paying premiums, a proportion of the proceeds are included based on the premiums paid by the trustee compared to the total proceeds paid. *See, Silverman v. Comm.*, 61 TC 338 (1973), *aff'd. sub non In re Estate of Silverman*, 521 F.2d 574 (2d Cir. 1975) and *Estate of Friedberg v. Comm.*, 63 TCM 3080.

[D] Technical defect in policy ownership

A perceived mechanical application of inclusion from the rules set forth above, should not leave one to conclude that a deficit in title ownership in the decedent will require estate inclusion. Take a look at PLR 86100168 in which the Service ruled that the proceeds of an insurance policy were not included in the decedent's gross estate, even though the policy named the decedent as the owner. The decedent's corporate employer had been required to take out the policy by an institutional investor and all of the parties understood that the corporation would own the policy. Inclusion was not required because decedent was mistakenly named.

[E] Not included *per se*

No includibility *per se* occurs merely because of the existence of a fiduciary power, provided the power cannot be used in any way to benefit the insured, so ruled by the IRS in Rev. Rul. 84-179, 1984-2 CB 195.

[F] Borrowing to pay premiums

In PLR 9809032 the Service ruled that decedent did not possess incidents of ownership in life insurance policies he transferred to trust as a result of loans he made to the trust to pay policy premiums. The ruling stated that payment of premiums is irrelevant in determining whether a decedent retained any incidents of ownership in the policy proceeds, citing *Estate of Leder v. Comm.*, 893 F.2d 237 (10th Cir. 1989) and *Estate of Headrick v. Comm.*, 918 F.2d 1263 (6th Cir. 1990).

§7.10 *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).

8 SCHEDULE E - JOINTLY OWNED PROPERTY

§8.01 *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, Schedule E, 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, General Information, 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?" Form, General Information, p. 3.

Property is reported on Schedule E not because of the type of property but because of the form of ownership. In fact, almost any type of property can be reported on Schedule E because almost every type of property can be owned jointly. But, consequences flow from reporting property on Schedule E.

Cash in jointly owned bank accounts is not considered available to pay debts, taxes and costs of administration, and the estate sooner qualifies to deduct expenses of sale. Qualified jointly owned property passes automatically to the surviving spouse and in the absence of disclaimer, is unavailable to fund a bypass trust or QTIP trust. Jointly owned accounts, which by definition are not owned with the spouse, in the absence of disclaimer, do not pass to the surviving spouse and do not qualify for the marital deduction. Further, jointly owned property reported on Schedule E is unavailable to fund any gifts made under the will. Qualified jointly owned property may not receive a discount for lack of marketability of an undivided interest with the whole value counting towards the filing threshold.

[A] 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 partnership interest itself is jointly owned. Form, Schedule E, p. 18.

[B] 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 spouses' interests.

Under Texas Probate Code Section 46 spouses are permitted to agree in writing that all or any part of their community property shall belong to the surviving spouse without going through probate upon the death of the first spouse. The deceased spouse's one-half interest in the community property subject to survivorship rights will be included in the deceased spouse's gross estate, presumably listed on Part 1, and will qualify for the marital deduction and not be taxed upon the death of the first spouse to die. Both halves will receive a step-up in basis under IRC § 1014(b)(6). See Rev. Rul. 87-98, 1987 CB 206.

[C] 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 and possibly also the state law. For real property located in a state other than that of the preparer, the preparer may need to get an opinion from an attorney of that state as to whether the language of the deed creates property that is jointly owned. The preparer should request that the personal representative provide copies of all signature cards, account agreements, and deeds for review.

§8.02 *Qualified joint interests*

[A] "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:

(1) Tenants by the entirety, IRC § 2040(b)(2)(A), (not available under Texas and some other state laws); or

(2) Joint tenants with rights of survivorship if the decedent and the decedent's spouse are the only joint tenants. IRC § 2040(b)(2)(B).

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, Schedule E, p. 18. An item reported on Part 2, is included in decedent's estate based upon the amount of consideration furnished by each spouse. Property held jointly with a spouse not a U.S. citizen may be treated as qualified joint interest property if the property is contributed to a qualified domestic trust (QDOT) discussed in Chapter 17, prior to filing the estate tax return. IRC § 2056 (d) (2).

A party other than the spouses may hold an interest in the same property as long as the other party's interest is not a jointly owned interest such as a co-tenancy. An example would be where the decedent and the spouse owned a 60% interest jointly with rights of survivorship while an unrelated party owned a 40% interest as a co-tenant.

[B] Where reported

Qualified joint interests are reported on Part 1 and all other joint interests are reported on Part 2. Form, Schedule E, p. 18.

[C] Value

One-half of a qualified joint interest is included in the decedent's estate regardless of the amount of consideration provided by the decedent and the decedent's surviving spouse, and the decedent's one-half interest will of necessity qualify for the marital deduction. Valuation discounts may not be available for the decedent's one-half, because of the mandatory valuation provisions of IRC § 2040(b).

TAM 200104008 addressed the proper reporting of a qualified joint interest residence encumbered by a mortgage. The executor reported half the value of the residence on Schedule E, Part 1, one-half of the mortgage on Schedule K, and the value reported on Schedule E without any reduction for Schedule K as the marital deduction on Schedule M. This approach gave a net decrease in the net estate by the amount of the reported mortgage. The TAM, not agreeing with the executor's approach, said that the proper way to report was (i) one-half the value of the residence without reduction for the mortgage balance is included in the gross estate under IRC § 2040(b) and Treas. Reg. §20.2053-7, (ii) one-half of the mortgage balance is deductible under either IRC § 2053(a)(3) or IRC § 2053(a)(4), according to Rev. Rul. 79-32, 1979-2 CB 328, and (iii) the marital deduction is the amount of the residence included in the gross estate reduced by one-half the outstanding balance of the mortgage. The TAM approach gives a net inclusion of zero.

[D] Qualified joint interests and unified credit

PLR 200025032 shows the tax planning limitations of qualified joint interests. The decedent wanted a brokerage to transfer a qualified joint account with his spouse into his own name so his bypass trust would be fully funded. The brokerage firm failed to make the transfer before death, and the

bypass trust was underfunded. The spouse made an agreement with the brokerage firm to return the amount necessary to fully fund the bypass trust and the brokerage firm would then fund the account. The IRS ruled that the additional amount would not be treated as passing from decedent, but rather as a transfer by the spouse. It seems to this author that a timely disclaimer by the spouse would have cured the planning problem, where this assignment failed.

[E] Pre-1977 joint interests

For survivorship, property acquired before 1977 in which the decedent contributed all the consideration a step-up in basis will be available for both halves of the survivorship property, and the surviving spouse may use DOD or AVD value as basis for the entire property. IRC § 2040(b)(1) did not apply to spousal joint interests created before 1977 and an amendment to the definition of "qualified joint interest" in IRC § 2040(b)(2) did not repeal, expressly or impliedly, the effective date of the 50 percent inclusion rule. *Gallenstein v. U.S.*, 92-2 USTC ¶60,114 (6th Cir. 1992); *Patten v. U.S.*, 116 F.3d 1029 (4th Cir. 1997). The Service has put this issue to rest in its acquiescence in *T. Hahn*, 110 TC 140 (2001) *acq.* AOD 2001-006.

§8.03 *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, Schedule E, p. 18.

[A] Value

The full value is not included in the gross estate, per IRC § 2040(a), if:

1. 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
2. It can be shown that any part of the property was acquired with consideration originally belonging to the surviving joint tenants.

As mentioned above for qualified joint interests, valuation discounts may not be available for the decedent's one-half interest because of the mandatory valuation provisions of IRC §2040(b). Similar valuation discounts may also be unavailable for joint interests if the regulations are strictly read to apply that a fractional portion of the value of the property is reported. Consider the following provisions of the regulations, Treas. Reg. §20.2040-1.

> (a) *In general*. A decedent's gross estate includes under section 2040 the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with right of survivorship, as follows:
>
> (1) To the extent that the property was acquired by the decedent and the other joint owner or owners by gift, devise, bequest, or inheritance, the decedent's fractional share of the property is included.
>
> (2) In all other cases, the entire value of the property is included except such part of the entire value as is attributable to the amount of the consideration in money or money's worth furnished by the other joint owner or owners. . . Such part of the entire value is that portion of the entire value of the property at the decedent's death (or at the alternate valuation date described in section 2032) which the consideration in money or money's worth furnished by the other joint owner or owners bears to the total cost of acquisition and capital additions. In determining the consideration furnished by the other joint owner or owners, there is taken into account only that portion of such consideration which is shown not to be attributable to money or other property acquired by the other joint owner or owners from the decedent for less than a full and adequate consideration in money or money's worth.
>
> The entire value of jointly held property is included in the decedent's gross estate unless the executor submits facts sufficient to show that the property was not acquired entirely with consideration furnished by the decedent, or was acquired by the decedent and the other joint owner or owners by gift, bequest, devise, or inheritance.
>
> ***
>
> (c) *Examples*. The application of this section may be explained in the following examples in each of which it is assumed that the other joint owner or owners survived the decedent:
>
> ***
>
> (2) If a decedent furnished only a part of the purchase price, only a corresponding portion of the value of the property is so included;
>
> ***
>
> (6) If the property originally belonged to the other joint owner and the decedent purchased his interest from the other joint owner, only that portion of the value of the property attributable to the consideration paid by the decedent is included;
>
> ***
>
> (8) If the decedent and his two brothers acquired the property by will or gift as joint tenants, one-third of the value of the property is so included.

[B] Amount excluded

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

In *M. Concordia Estate*, TC ¶45,173(M) the decedent's estate successfully excluded half of the value of a residence held by the decedent and her niece as joint tenants. The decedent was the sole owner and occupant of her residence but began exploring alternative living arrangements that would allow her two dogs to remain at the residence. She entered into an agreement with her niece and the

niece's husband pursuant to which the decedent deeded her residence to herself and the niece as joint tenants, in exchange for the niece and her husband permitting the decedent to live in their home and the husband agreeing to manage a separate rental property owned by the decedent. The Tax Court determined that the indexed fair rental value of the niece's home allocable to the decedent's occupancy was $136,187 or slightly more that half of the $270,000 fair market value of the residence. The court held that the consideration provided by the niece in exchange for acquiring an undivided one-half interest was sufficient to exclude half the residence's value from the decedent's gross estate under IRC § 2040.

[C] 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 has no bearing on this result.

[D] 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).

[E] 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, Schedule E, p. 18.

[F] 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. For example, jointly owned real estate is reported in the same manner as reported in schedule A. Form, Schedule E, p.18.

§8.04 *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. For example, jointly owned real estate is reported on Schedule E in the same manner as real estate should be reported on Schedule A. Form, Schedule E, p. 18.

§8.05 *Disclaimer of the joint interests*

[A] Previous IRS position

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. 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.

[B] 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 cannot disclaim any portion of the account attributable to the survivor's own contributions.

[C] Disclaimer and value

Let us assume a situation in which a qualified joint interest in real property is held by decedent and the value included in the estate is one-half the value of the whole pursuant to IRC § 2040(b). Let us also assume that within the nine month period the surviving spouse makes a qualified disclaimer of the decedent's interest and decedent's interest no longer passes under the survivorship terms to the surviving spouse, but rather it passes pursuant to decedent's probate estate and it will be funded into a trust pursuant to a pecuniary formula. It would seem that the mandatory valuation provisions of IRC § 2040(b) would apply in all instances of qualified joint interests, even ones as to which there is a qualified disclaimer. Obviously, the marital deduction is lost because the disclaimed interest no longer passes to the surviving spouse. But, does the interest fund pursuant to the pecuniary formula with or without a valuation discount for an undivided interest in real property? It would seem that if it is valued as a qualified joint interest that it should be valued the same way for funding, but so authority has been located. Another possibility is to no longer report and value the interest as a qualified joint

interest but rather as a joint interest, and take the valuation discount on the return. The problem with this approach is that both the statute and the regulations would suggest that the valuation rules are mandatory for joint interests that exist on decedent's death (or alternate valuation date). The disclaimer creates the legal fiction that the disclaimant was deceased at the death of the prior owner, but the legal fiction does not necessarily carry over to valuation issues. Yet, the disclaimer regulations clearly state that as a result of disclaimer the decedent's interest is no longer included in the estate under IRC § 2040 (and hence no longer reported on Schedule E) but rather included under IRC § 2033. Treas. Reg. §25.2518-2(c) (14). The disclaimer regulations provide strong support that the valuation rules of IRC § 2040 no longer apply in the event of disclaimer.

[D] Disclaimer and basis

There may be a planning opportunity under the disclaimer regulations for an increased step-up in basis if there is a disclaimer of non-community joint property. If the decedent held $1,000,000 in a joint brokerage account with decedent's spouse, and if the surviving spouse disclaims $500,000 from the joint account, that $500,000 becomes probate property includable under IRC § 2033 at 100% of the half value and receives an increased basis. Of the remaining $500,000, non-disclaimed portion includable under IRC § 2040, 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. Beverly R. Budin, *Comment*, ESTATE AND GIFT TAX SECTION MEETING, ABA Tax Section, January 10, 1997 (apparently commenting on Example 14, Treas. Reg. §25.2518-2(c)(14).

§8.06 *Alternate valuation*

When is a qualified joint interest distributed to the survivor for purposes of determining the alternate valuation date? The regulations imply that the interest is distributed on the date of death but appear to except joint interests from the general rule. The regulation states, "the phrase 'distributed, sold, exchanged, or otherwise disposed of' comprehends all possible ways in which property ceases to form a part of the gross estate." Treas. Reg. §20.2032-1(c). Property is "distributed" upon the first to occur of "(ii) the segregation or separation of the property from the estate or trust so that it becomes unqualifiedly subject to the demand or disposition of the distributee, or (iii) the actual paying over or delivery of the property to the distributee," *Id.*, but these latter provisions appear to be limited to property included under IRC §s 2035 through 2038 and 2041, but not 2040. The regulation, in stating that "Property may be 'sold, exchanged, or otherwise disposed of' by:...(iv) a surviving joint tenant or tenant by the entirety;" *Id.* implies that death of the joint tenant is not distribution even though upon death the joint property becomes unqualifiedly subject to demand or disposition by the surviving joint tenant. In Rev. Rul. 59-213; 1959-1 CB 244, the Service decided that transfer by the surviving joint tenant to a revocable trust was not a disposition, a question the Service could not reach without first deciding that the death of the joint tenant was not itself a disposition. The distribution or disposition apparently must be an affirmative act by the surviving tenant other than just surviving the decedent.

§8.07 *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).

9 SCHEDULE F- OTHER MISCELLANEOUS PROPERTY

§9.01 *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.

[A] 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." Form, Schedule F, p.19.

[1] Instructions misread question

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 ...

Nothing significant turns on this misreading, however, because it correctly states the requirement to report the details and the conditions in which an appraisal is required.

[2] Appraisal required

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, Schedule F, p. 20. This statement under oath, 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 personally seen the IRS attempt to enforce the demands of this regulation.

Without making specific reference to the regulation, the Tax Court in *Trompeter v. Commissioner*, TC Memo. 2004-27; No. 11170-95, effectively enforced its provisions in not accepting an appraisal by an auction house.

> We are mindful that the estate's Federal estate tax return contains an "appraisal" opining that the decedent's home was filled mainly with minimal value assets. That document was prepared by Butterfield & Butterfield (Butterfield) on or about May 13, 1993, and purports to list the fair market values as of March 18, 1992, of 161 single or groups of assets which were viewed by Butterfield within the decedent's home. . . .
>
> ***
>
> We give little regard to this "appraisal". We do not believe that an astute, strong-minded, self-made multimillionaire like the decedent, who indisputably collected only the finest and most valuable gold coins, gemstones, and items of jewelry, and who received enormous pleasure from flaunting his possessions before others, would purchase assets with such minimal values as listed by Butterfield. Nor does the appraisal state the rationale underlying its low values; it merely recites a brief general description of the asset with its proffered value.
>
> We also know little about the appraiser (e.g., her credentials) or the terms or conditions underlying the appraisal. We do know, however, that the appraiser generally walked through the decedent's home, eyed most of the items in the home, and appraised them on the spot.

The penalties of perjury statement on page one of the return signed by the executor, may effectively meet this requirement without an additional, specific penalties of perjury statement for each appraisal.

The 2003 Directory of Professional Appraisers published by the American Society of Appraisers lists qualified appraisers of African sculpture; aircraft; antique firearms, armor and militaria; antique furniture; antiques and decorative art; Asian art; audio-visual media recordings; automatic musical instruments; automotive specialties; books; clocks; computers and hi-tech personal property; dolls and toys; ethnographic art; fine arts; fine arts photography; firearms; Japanese prints; machinery and equipment; manuscripts; Native American art; numismatics; oriental rugs; Pre-Columbian art; residential contents-general; silver and metalware; sports collectibles and memorabilia; textiles-general; textiles-quilts; wines-fine and rare; and yachts.

[3] Appraisal review

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; your 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 generally correct statement of fair market value, yet knowledge of *all* relevant facts is not required.]

> 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 authentic or 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 authentic or 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 give 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 "very fine" 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.

This language comes from the appraisal agreement of a major auction house:

> Such appraisal represents _____'s opinion as to the value of the Property, but _____ makes no representation or warranty with respect to the authenticity, authorship, period, culture, source, origin, provenance, description or condition thereof. This appraisal is not furnished, and may not be relied upon by anyone, in connection with any purchase, sale or exchange of the Property or any other commercial transaction relating thereto.

This language is somewhat understandable given that appraisals are a side business done to encourage owners to place their items for auction and that items sold at auction are sold without warranty as to authenticity, yet all of the factors as to which there is no warranty or even a representation, are critical in determining fair market value and some, such as description and condition, should be within the knowledge and determination of the appraiser. Why no warranty as to description and condition?

[4] Actual rules

Rev. Proc. 65-19, 1965-2 CB 1002, provides a procedure for use of actual sales prices for valuation for estate tax purposes of items of tangible personal property sold at public auction or through a newspaper advertisement. The procedure applies to items of tangible personal property that are frequently obtained by members of the general public at a public auction or through sales that result from advertisements placed in the classified section of a newspaper by individual owners who are interested in selling such items. Where there is a bona fide sale on items of tangible personal property as a result of an advertisement in the classified section on a newspaper and the property is of a type often sold by owners by such means, or there is a bona fine sale of an item of tangible personal property at a public auction, the price for which it will be sold will be presumed to be the retail sales price of item on the applicable valuation date if the sale is made within a reasonable period following the applicable valuation date and there is no substantial change in market conditions or other circumstances affecting the sale of similar items between the time of the sale and the applicable valuation date.

[5] Provenance

The provenance, the origin and prior ownership, of an item of personal property can have a tremendous effect on value. A piece of cake from your author's wedding has no publicly recognized value, but a piece of cake from the wedding of the Duke and Duchess of York may have substantial value. In using auction reports, make sure that appropriate adjustments are made for the provenance of the comparable as well as the subject. Andy Warhol's cookie jar collection had value because it was Andy Warhol's collection.

[B] 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." Form, Schedule F, p. 19. This question may require a "yes" answer, even though the bonus or award is not included in the gross estate. A bonus or award, paid after death by the decedent's employer is includable 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, [no longer in print] at 110. A bonus or award paid after death by the decedent's employer is not includable 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, amplified by Rev. Rul. 68-124, 1968-1 CB 44.

[C] 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." Form, Schedule F, p. 19.

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. Let the explanation convey a meaningful reason that the property is excluded: Decedent and his daughter had a joint box and ladies jewelry belonging to her is not included.

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. Tex. Prob. Code §36D (Vernon's 1980).

In *Trompeter v. Comm.*, TC Memo 1998-35, the Tax Court found that the executors intentionally understated the decedent's taxable estate with the specific intent of evading tax, in part because of falsely stating that the decedent did not have access to a safe deposit box.

> Third, the estate failed to report any value for the assets in the safe deposit box at Union Bank, and, in an attempt to conceal the existence of this box, the co-executors stated on the estate tax return that decedent did not own or have access to a safe deposit box at the time of his death. In a further attempt to conceal the existence of the safe deposit box at Union Bank, the co-executors failed to report the existence of the safe deposit box at First Interstate Bank, choosing only to report a value for 35 of the coins which were found therein. [fn: The estate would have reported the existence of the safe deposit box at First Interstate Bank by stating on the decedent's estate tax return that he had access to a safe deposit box when he died. Such a statement would most likely have led respondent to investigate further the circumstances of the box, which could have led respondent to discover the safe deposit box at Union Bank.] In yet another attempt to conceal the contents of the safe deposit box at Union Bank, Ms. Gonzalez [the executor] falsely answered in the negative when Ms. Bates [estate tax return preparer] asked her whether the decedent owned any jewelry or diamonds when he died. The decedent did own jewelry and diamonds at that time, and these assets were kept in the safe deposit box at Union Bank.

Your author fails to see how not reporting a box at First Interstate Bank concealed the existence of a box at Union Bank. Both boxes were concealed when the third question was falsely answered "no."

§9.02 *Property reported*

Schedule F is to list all items that must be included in the gross estate that are not reported on any other schedule. Form, Schedule F, p. 20. In a sense, Schedule F is the "catch-all."

The regulations, Treas. Reg. §20.6018-3(a), provide not just for the property listed on Schedule F, but for all items on the return:

> In listing upon the return the property constituting the gross estate (other than household and personal effects . . .), the description of it shall be such that the property may be readily identified for the purpose of verifying the value placed on it by the executor.

[A] Checklist

Checklist 7, Schedule F, Miscellaneous Property Checklist, shows the items to be listed on Schedule F as adapted from RIA's Complete Guide: Federal Estate Tax Return [no longer in print] at 112.

Checklist 7
Schedule F, Miscellaneous Property Checklist

- ❑ Accounts receivable
- ❑ Aircraft
- ❑ Airline frequent flier miles*
- ❑ Animal trophies*
- ❑ Antiques
- ❑ Art objects*
- ❑ Automobiles*
- ❑ Boats
- ❑ Bonus claims (see Salary)
- ❑ Books*
- ❑ Business interests (unincorporated)*
- ❑ Checks, unnegotiated*
- ❑ Claims*
- ❑ Clothing (see "wearing apparel")
- ❑ Coin collections*
- ❑ Collections, miscellaneous*
- ❑ Commissions, claims to
- ❑ Compensation, decedent's right to
- ❑ Computers*
- ❑ Contingent claims
- ❑ Contingent remainder, not extinguished by decedent's death
- ❑ Contraband*
- ❑ Co-partnership interest
- ❑ Copyrights
- ❑ Costumes (see "wearing apparel")
- ❑ Crops (growing at decedent's death)*
- ❑ Currency, collections
- ❑ Currency, foreign
- ❑ Debts due decedent (other than*mortgages and notes)
- ❑ Deferred compensation claims (see "Salary")
- ❑ Engravings
- ❑ Escrow accounts
- ❑ Estate income, accrued at decedent's death
- ❑ Estates, interest in*
- ❑ Etchings
- ❑ Farm machinery*
- ❑ Farm products and growing crops
- ❑ Fees, uncollected
- ❑ Fire insurance premiums prepaid for periods after death
- ❑ Firearms, guns, rifles
- ❑ Furnishings
- ❑ Furniture
- ❑ Furs
- ❑ Gemstones*
- ❑ Goodwill
- ❑ Horses, thoroughbred
- ❑ Household goods and personal effects*
- ❑ Individual retirement accounts (IRA)*
- ❑ Insurance Renewal Commissions*
- ❑ Intellectual Property*
- ❑ Interests in business
- ❑ Jewelry*
- ❑ Joint ventures
- ❑ Judgments*
- ❑ Lawsuits*
- ❑ Leaseholds not reportable as real estate on Schedule A
- ❑ Life estates*
- ❑ Life insurance (on life of person other than decedent)*
- ❑ Limited liability companies*
- ❑ Livestock*
- ❑ Loans (other than mortgages and notes)
- ❑ Lottery prizes*
- ❑ Marital deduction (Section 2044) property*
- ❑ Medical insurance reimbursement due decedent at death
- ❑ Musical instruments*
- ❑ Name, voice, signature and likeness*
- ❑ 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 in sole proprietorship*
- ❑ Receivables and refunds, miscellaneous
- ❑ Refunds, general*
- ❑ Remainder interests*
- ❑ Residuals
- ❑ Reversionary interests not reported as real estate on Schedule A
- ❑ Rights
- ❑ Royalties
- ❑ Salary*
- ❑ Sculpture
- ❑ Section 2044 property
- ❑ Security deposits
- ❑ Severance pay claims
- ❑ Silverware*
- ❑ Social Security benefits (see "Checks Unnegotiated")
- ❑ Sole proprietorships
- ❑ Sports memorabilia (see "Wearing apparel")
- ❑ Stamp collection
- ❑ Statuary
- ❑ Stock options*
- ❑ Tax refund claims*
- ❑ Trademarks
- ❑ Trade secrets
- ❑ Trust funds, shares in*
- ❑ Trust income accrued to decedent's death
- ❑ Trust interests
- ❑ Vases
- ❑ Wages (see "Salary")
- ❑ Wearing apparel*
- ❑ Yachts

Items marked by an asterisk (*) are discussed in this Chapter 10.

[1] Airline frequent flier miles

Almost all of the frequent flier programs prohibit transfer, but according to an article by James L. Dam, "New Asset in Divorce and Estate Planning: Frequent Flyer Miles," Lawyers Weekly USA, November 29, 1999, there is a grey market for frequent flyer miles and there are several sites on the internet: awardtraveler.com, airawards.com, and mrmileage.com. These sites will give an idea of the value of the miles. According to the article, the value you get from the sites is a better indication of value that what the airlines charge for miles to bring an account up to a sufficient amount to buy a ticket. The article also has addresses and rules for transferring miles and points. Southwest Airlines Rapid Rewards tickets can be valued by looking in the classified section of the newspaper for brokers who buy the tickets. Yet the most interesting item your author found in United's May 2004 in flight magazine was this notice: "**Don't buy or Sell United Awards.** Any person selling, purchasing or bartering United or United Mileage Plus certificates, award tickets and mileage credit may be liable for payment of full fare, damages, litigation and transaction costs. All such items are void and may be confiscated."

The IRS in Announcement 2002-18 stated that frequent flyer miles are not income so they should not be treated as IRD.

[2] Animal trophies

The market for animal trophies is limited because few people want to own a mount shot by another person. They have great sentimental value to the original owner and high basis based upon the cost of the hunt. In appraising animal trophies use comparable sales and not replacement cost to get the lowest value, and rely on *Robson v. Comm.*, (9th Cir. 1999) 83 AFTR 2d 99-180. In an income tax charitable deduction case, the taxpayers' expert based the appraisal of trophy mounts on the replacement cost methodology. Replacement cost is a relevant measure of value where the property is unique, the market is limited, and there is no evidence of comparable sales, but the court found that there was a market for items comparable for the trophy mounts and that legal restrictions imposed on buying and selling mounts do not preclude the use of the comparable sales method.

[3] Antiques

The discussion in "Art objects" with regard to the Art Advisory Panel also applies to antiques with an individual reported value in excess of $20,000.

[4] Art objects

Fine art poses many fascinating valuation issues requiring a knowledgeable appraiser.

> An appraiser needs to be very familiar with the current market and its trend lines in his or her area of specialization in order to accurately value works of art, especially for those appraisals that will be submitted to the Internal Revenue Service (the "IRS"). There are many factors that can affect the value of a work of art and it is important that an appraiser has the knowledge and experience to accurately weigh these factors when assigning a value to a work of art. Some of these factors are the provenance, or history of an object; rarity; quality; condition; and fashion, as society's taste changes over the years and something that was collected in the 1960s may not be so popular today, or the reverse. Lash, "Appraisals of Tangible Personal Property," Christies, Inc., 2001, p.1.

[a] Blockage discount

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, has also been applied to valuation of works of art. *See*, *Estate of O'Keeffe*, TCM 1992-210 (the estate of painter Georgia O'Keeffe), *Estate of David Smith*, 57 TC 650 (1972), acq. 1974-2 CB 4 aff'd, 510 f.2d 479 (2d Cir.), cert. denied, 423 U.S. 827 (1975) (425 pieces of metal sculpture) and *Calder v. Comm.*, 85 TC 713 (1985) (gift tax case; art of Alexander Calder). see also, *Estate of Nevelson v. Comm.*, TC Memo 1996-361 (entry of a motion of stipulation not deferred, despite executor's allegations that the estate would incur additional administration expenses relating to sales of art necessary to raise cash for the payment of taxes and other art-related expenses, the executor cannot currently pay decedent's gift taxes because the estate is short on cash, the estate will have to consummate a "substantial transaction" in order to pay decedent's gift taxes, and he could not sell the estate's assets in the near future because he would receive less than fair value).

With art, as well as any other asset, a lower value for estate tax purposes can trigger income tax when latter sold. Inheritors of an art gallery, were not permitted to calculate the gallery's cost of goods sold using the undiscounted value of the gallery's collection of artwork as determined by the IRS Art Advisory Panel, but rather were required to use the discounted value as determined for estate tax purposes, in *Janis v. Comm.*, TC Memo. 2004-117. The duty of consistency was applied.

[b] Appraisal requirements

For income tax purposes only, Rev. Proc. 66-49, sets forth a procedure to be used as a guideline by all persons making appraisals of donated property. While limited to income taxes, the appraisal

requirements are a useful guideline in preparing appraisals for estate tax purposes. The revenue procedure states that the procedures are appropriate for unique properties such as art objects. The appraisal report should contain at least the following:

(1) A summary of the appraiser's qualifications.

(2) A statement of the value and the appraiser's definition of the value he has obtained.

(3) The bases upon which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or disposition of the property.

(4) The date as of which the property was valued.

(5) The signature of the appraiser and the date the appraisal was made.

The procedure sets for the kind of data that should be contained in a typical appraisal for art objects, and paintings in particular.

(1) A complete description of the object, indicating the size, the subject matter, the medium, the name of the artist, approximate date created, the interest transferred, etc.

(2) The cost, date, and manner of acquisition.

(3) A history of the item including proof of authenticity such as a certificate of authentication is such exists.

(4) A photograph of a size and quality fully identifying the subject matter, preferably a 10" 12" or larger print.

(5) A statement of the factors upon which the appraisal was based, such as:

a. States of other works by the same artist particularly on or around the valuation date.

b. Quoted prices in dealers' catalogs of the artist's works or of other artisits of comparable statute [stature].

c. The economic state of the art market at or around the time of valuation, particularly with respect to the specific property.

d A record of any exhibitions at which the particular art object had been displayed.

e. A statement as to the standing of the artist in his profession and in the particular school or time period.

[c] Stolen art objects

The ruling in TAM 9152005 that the value of Medieval 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. The taxpayer may have been overly aggressive in taking the position that there was no market for stolen Medieval art objects and therefore the value was zero. The estate also argued that if the objects were includable in the gross estate at their fair market value then the estate should be entitled to a deduction under IRC § 2053 for claims against the estate by the legitimate owners of the art objects; but under the law of Texas the period in which claims could be brought had already run. The IRS appears to have fallen into the trap of considering subsequent events, because at the valuation date, the DOD, the statute of limitations on making claims had not yet run.

[d] Auction sales

In *Estate of Robert Scull*, TC Memo 1994-211, the tax court determined that the fair market value of an item sold at auction is the aggregate of the hammer price and the buyer's premium.

[e] Minority interests

The text of the *IRS Valuation Training for Appeals Officer's Coursebook*, p. 5-14, has an interesting discussion that is quoted in whole:

> The Art Advisory Panel [which assists the IRS in determining the authenticity and fair market value of works of art] and Art Appraisal Services [actually the National Office Art Advisory Services, appraisers who provide assistance to IRS agents and appeals officers] do not recommend any discount be applied to the value for a minority ownership or interest in art works for charitable contributions or estate and gift tax cases.
>
> Fractional interests are not uncommon in the art world. Donations of fractional interests in art objects is not uncommon. The Service does not apply a discount to donations of fractional interests in art objects.

Rev. Rul. 57-293 [1957-2 CB 153] deals with the deduction allowed on a gift to charity of an undivided fractional interest in an art object. It states that the deduction will be equal to "that value which bears the same ratio to the value of the entire interest that the donated undivided (fractional) present interest in the art object be to the entire interest therein." The Service follows the same principal [sic] in estate and gift tax matters.

> While it is not unusual for art dealers or family members to buy art objects jointly, there is essentially no market for selling partial ownership interests in art objects without contemplation of sale. The purchase of a partial interest in an art object or collection is really without foundation in the market place. Art is not fungible. While discounts for minority ownership has been applied to stocks and real estate, art works are very different. Art is not a going concern but a unique asset.

> The definition of fair market value contemplates that the hypothetical buyer and seller will act in their own best economic interests. Consequently, the best interest of a seller would not be to sell the fractional interest, but rather sell the entire property and divide the proceeds.

Real estate, like art, is a unique asset that garners a discount for a partial interest. Because there is no established market for partial interests in art should not nullify a discount, but rather supports a discount for lack of marketability.

Despite the quote above from the Coursebook, this author would take a discount and prepare to defend it in the event of an audit. In *Estate of Robert S. Scull v. Commissioner*, 67 TCM (CCH) 2953 (1994), the Tax Court allowed a 5% discount for a 65% undivided interest in an art collection that was owned by the decedent at the time of his death.

[f] IRS-determined value

Rev. Proc. 96-15, IRD 1996-3, sets forth a procedure by which certain high valued art objects can be valued for estate tax purposes, by applying for a statement of value and paying the specified user fees. The author has never used this procedure and questions if it is a good idea to use the IRS as your appraiser. The appraisal must be sought after the death of the decedent. The estate pays a user fee to the IRS of $2,500 for the first three items transferred and $250 for each additional item, and the estate has already obtained a qualified appraisal by a qualified appraiser for each item of property and at least one of the items of property has a value of $50,000 or more. This procedure is the only time an estate would need to get a qualified appraisal. The appraisals are submitted to the Service with a ruling request, and it will generally be useful primarily for artwork transferred to non-charitable beneficiaries.

[g] Art Advisory Panel

The Art Advisory Panel of the IRS generally reviews any audited return in which an item of art is valued at $20,000 or more, or in which the IRS has reason to believe that the fair market value may exceed $20,000. The Art Panel is charged with reaching fair values and not being an advocate on behalf of the IRS for higher or lower values, depending on the situation. When the Art Panel considers a given item it does not know if a value issue arises in a charitable contribution case in which the taxpayer wants a high value or the IRS seeks a low value or an estate or gift tax case in which the taxpayer seeks a lower value and the IRS a higher value. In 2001 in estate and gift tax cases the Art Panel accepted the reported values in about one-half of the cases and in the one-half of cases where adjustments were made, two-thirds resulted in values increased by 97% and one-third resulted in reductions of about 37%. A report detailing the Panel's determination, together with a list of the participating panelists, is prepared and given to the taxpayer. Taxpayers can request reconsideration of an adjusted claimed value if they provide additional information or new probative evidence, which goes to a subsequent panel if deemed substantive by the Panel's staff.

In 2001 the Panel reconsidered 46 estate items in 5 taxpayer cases originally valued at $17,922,874 by the taxpayers and $26,139,094 by the Panel. After reviewing additional information and revised taxpayer values of $16,828,250 the Panel recommended $23,559,555 on these items. Apparently on reconsideration the Panel knows that the taxpayer seeks a lower value. Art Appraisal Services, part of IRS Appeals in Washington considered 16 estate cases with numerous items and claimed values of $14,176,365. These involved the valuation of various objects, such as art of Africa and the Americas, Far Eastern and Asian art, prints, furniture, photographs, decorative arts, antiquities, musical instruments, religious artifacts, and historical properties. Annual Summary Report for 2001, Art Advisory Panel of the Commissioner of Internal Revenue.

In the Art Advisory Panel's 2004 Summary Report it was reported that 1002 items were reviewed in 107 estate and gift taxpayer cases. Of those 32 percent were accepted, 26 percent required further staff development, and adjustments were recommended in 42 percent of the reviews. In the adjustments, 32 percent were adjustments upward and 10 percent were adjustments downward.

[5] 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. Published lists, such as NADA books of used car values, usually have a sale to the dealer 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).

At kbb.com you can get the Kelley Blue Book online with both a price you can expect to pay if selling to a used car dealer and a private party value, which represents what you might expect to pay for a used car when purchasing from a private party and what you might expect to receive when selling your own used car to another party — the willing buyer, willing seller test. The listings are not historical so the closer to the date of death this service is actually used, the more accurate the value will be.

Rev. Proc. 65-19, 1965-2 CB 1002, provides that items of tangible personal property frequently obtained by members of the general public through sales that result from advertisements placed in the classified section of a newspaper by individual owners who are interested in selling such items may be valued based upon the sales price.This appears to be particularly applicable to used automobiles. Where there is a bona fide sale of an item of tangible personal property as a result of an advertisement in the classified section of a newspaper and property of that type is often sold by such means, the price for which it is sold will be presumed to be the retail sales price of the item at the time of the sale. Such actual sales price will be presumed to be the retail sales price of the item on the applicable valuation date if the sale is made within a reasonable period following the applicable valuation date and there is no substantial change in market conditions or other circumstances affecting the value of similar items between the time of the sale and the applicable valuation date.

[6] Books

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

These thoughts on books came from "Book Appraisal FAQ" on collectbooks.about.com. The value of a book depends upon supply and demand and particular features such as provenance and condition motivate both. Provenance includes the ways a particular copy of a book may be associated with its author (inscribed by the author, the author's own copy, or annotated by the author) or with a famous person (owned by a historical notable or celebrity). Condition can loosely include age, limited editions, and fine binding. Bent corners, creases and stains on the biding and missing or loose pages and tears, creases, writing, marking, soiling, and scuffing on pages are all defects affecting condition. The importance of condition varies inversely with rarity, because a rare book in poor condition will likely be less decreased in value by another rare copy in better condition. Even an old rare book, though scarce, may be of little value if the demand is even scarcer. Age alone is a determinate of value only for books that predate the invention of printing. Books affected most by condition are modern (1900 and thereafter) first edition fiction. A scholarly work may not be valued less when a dust jacket is absent, but value of modern literary works will be considerably diminished without its dust jacket. Great supply versus low demand makes some books of low value: modern textbooks, *Readers' Digest Condensed Books*, encyclopedias and especially encyclopedia yearbooks, book club editions, and books published post 1970 in less than ideal condition. References about books that might be consulted are *American Book Prices Current*; Allen and Patricia Ahearn, *Collected Books: The Guide to Values* (1997); Allen and Patricia Ahearn, *Book Collecting 2000* (1999); *AB Bookmans Book Price Index* (contains prices from catalogues, which are prices at which books are offered and not necessarily purchased); *Huxtables;* and *Book Prices: Used and Rare.* Booksellers may be qualified appraisers (but make sure the correct test of value is applied as the value of what the bookseller will *pay* rather than for what the bookseller will *sell* may invite challenge from the IRS). A qualified appraiser may also be found listed on Websites of major university libraries or by contacting the Society of American Archivists. On the Web, ABEbooks and Bibliofind can give an approximation of value.

[7] 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, Schedule F, p. 20.

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

Schedule F, p. 20. 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). Your author suggests that the IRS wants these items valued as part of the business rather than separately so a premium for goodwill can be included. See the discussion at Schedule B regarding "Stock in closely held corporations," much of which is applicable to all business interests, incorporated and unincorporated.

[8] Checks, unnegotiated

Unnegotiated checks on which the decedent is the payee, rather than the payor, are assets of the estate properly reported on Schedule F. A preparer may never encounter one exception to this rule, because most Social Security recipients now have direct deposit and receive benefits other than by check. In Rev. Rul. 75-145, 1975-1 CB 298, the IRS ruled that the value of a decedent's interest in uncashed Social Security benefit checks, jointly payable to him and his surviving wife, is not includible in his gross estate under either IRC § 2033 or IRC § 2041. The Social Security Act, 42 U.S.C. 402(d), provided a priority of persons other than the decedent's estate who are to receive payment under unnegotiated checks due a beneficiary at the time of death. The right of the decedent payee to the payment terminates with death and the decedent has no control over the designation of the beneficiary of the payments to be completed after his death. The ruling found that the decedent does not possess an interest in the uncashed checks sufficient to cause inclusion of their value in his gross estate under IRC § 2033. This ruling would not apply to unnegotiated checks in general, but is limited to Social Security benefit checks. But, as to property in general the ruling stated, "Section 2033 does not embrace interests held by the decedent during his life but which terminate on his death. [citations omitted] The decedent must at the time of his death possess rights that he can transmit to a survivor."

[9] Claims

According to the instructions, 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, Schedule F, p. 20. See "Tax refund claims" below.

[10] Coin collections

Because coins are also "cash," coin collections could also be properly listed on Schedule C, but because they are listed at the appraised value rather than face, they more properly should be listed on Schedule F. Factors affecting coins are age, rarity, and condition. Determining the proper grade of a coin is necessary to determine its value.

In *Trompeter v. Comm.*, TC Memo 1998-35, at issue was the value of the decedent's collection of gold coins. The Tax Court took issue with all of the valuation experts, and used the value placed on the coins by the decedent shortly before death. The court rejected one expert's "tainted status" discount as well as a blockage discount. The court found that another appraiser inappropriately assumed that the coins would be sold as a group and not individually.

Contrast this statement to advice for the layman in Halperin, Ivy & Rohan, *The Rare Coin Estate Handbook*, pp. 53-4:

> The IRS stipulates that the 'bulk sale method' appraisal should be used. In other words, what the collection would have brought if sold in one bulk sale to a dealer on the date of death. This is very important, especially for valuable collections that are part of large estates, and is a benefit to the heirs.
>
> If a dealer would buy the entire collection outright for $100,000, that is the value that should be used for the date of death appraisal. The benefit is that if the collection is sold at a large public auction held at a location where many collectors and dealers can attend, it could easily bring $130,000-$150,000. However, for the purposes of estate taxes, which could be as much as 55% on estates valued above $1 million dollars, the applicable percentage is only levied against the $100,000. If you end up consigning the collection to auction or shop it around for the best offer, you would only be responsible for the much lower capital gains rate on the amount over $100,000. Consult your attorney or tax advisor.

[11] Collections, miscellaneous

Collectors Insurance Agency, Inc., www.collectinsure.com, insures numerous collections, which shows that almost anything can be a collection: American Indian collectibles, animation art, autographs, badges, beanie babies, bears, books, bottles, ceramics, china, Civil War, clothing, coins, comics, crystal, currency, dolls, entertainment/military/political/sports memorabilia, figurines, glass, jukeboxes, limited edition collectibles, maps, medals, model cars/trains, musical instruments, ornaments, paper collectibles, patches, pens, photos, pins, plates, postcards, posters, pottery, prints, records, stamps/postal history, sports cards, slot machines, stocks/bonds, textiles, toys, trade cards and over 100 other collectibles. Policies issued do not require a detailed inventory, and the insurance is based on replacement cost, so the policy should not be used to value such collections. This site also has links to other sites on collections. Usually the preparer does not want to identify collections because that may increase their

value, but the first question to Schedule F, discussed above, inquires if the estate included any collections of a value of $10,000.

In *Trompeter v. Comm*., TC Memo 1998-35, the executors were assessed fraud penalties, in part, for failing to report a gun collection and a music collection that the decedent's personal accountant, as instructed by decedent, listed on a statement of decedent's assets with estimated values. On remand from the Ninth Circuit, the Tax Court in TC Memo. 2004-27; No. 11170-95, elaborated upon using the value given by the decedent.

> When he died, the decedent owned a music collection consisting of reel-to-reel tapes (and to a lesser extent records) and three or four tape players. The decedent had been collecting reel-to-reel- tapes for approximately three decades, and his life's goal was to own the best collection of reel-to-reel tapes which money could buy. The decedent's music collection was unique and of fine quality, consisting mainly of music from the 1920s and 1930s and including tapes of the famous Italian tenor Caruso and numerous other tapes of music from Latin America through music of the present day. The decedent kept his tapes at home in several rooms. In one room, in particular, the room where he routinely listened to his tapes on a high quality, highly sensitive sound system, the decedent covered one wall completely with his tapes.
>
> Henry Schiffer (Schiffer) was the decedent's accountant and a long-time friend. Once or twice a month, Schiffer would visit the decedent at his home to handle his accounting requirements or simply to converse with him in his music room or in his gazebo. For estate tax purposes, Schiffer prepared a one-page document entitled "ED TROMPETER ASSET LIST (NOT INCLUDING COINS) AS OF FEBRUARY 21, 1992". This document listed Schiffer's understanding of some (but not all) of the assets owned by the decedent as of that date and each asset's estimated fair market value. Schiffer generally obtained these estimates by asking the decedent his opinion as to each asset's value. Beforehand, Schiffer had advised the decedent that he should be conservative in estimating value for this purpose because the higher the value, the greater the estate tax. The document listed that the decedent's music collection had an estimated fair market value of $50,000 as of February 21, 1992.
>
> Gonzales took the decedent's music collection to her home in Florida after he died, and the coexecutors did not report any value for this collection on the Federal estate tax return. We find on the basis of Schiffer's document and testimony that the fair market value of this collection was $50,000 as of the applicable valuation date. We are mindful that the fair market value of this collection could be significantly higher than $50,000 given the voluminous size of the collection, the decedent's earnest desire to have the finest collection of reel-to-reel tapes which money could buy, the decedent's financial ability to fulfill that desire, and Schiffer's advice to the decedent to estimate the value of the listed assets conservatively.

The court also used the decedent's value for an unreported jade collection.

> The Schiffer document lists the value of the decedent's jade collection at $250,000 as of February 21, 1992. Schiffer obtained this value from the decedent. The decedent purchased $45,000 of jade from Lloyds on December 5, 1988. The decedent purchased other items of jade at other times.
>
> The coexecutors reported on the estate's Federal estate tax return that the only jade included in the taxable estate was two jade plaques with a fair market value of $2,500. The reported value equaled the amount of the Butterfield appraisal shown for those items. Taking into account the decedent's own valuation of his jade collection and allowing the estate credit for the reported value of the plaques, we find the fair market value of the remainder of the jade collection at $247,500 as of the applicable valuation date ($250,000 - $2,500).

In a footnote the court stated that the decedent's gun collection of approximately 10 was not as valuable as the other assets which he collected. Fn. 12.

[12] Computers

Computers the property of New York State domiciliaries pass to the decedent's surviving spouse by operation of law, regardless of the contrary provisions contained in decedent's will. New York Estates, Powers and Trusts Law, Section 5-3.1. In those instances in which the surviving spouse is not the executor of the estate, presumably the surviving spouse would be required to inform the executor of any records on the computer helpful in administering the estate.

[13] Contraband

To your author, it seems that illegality of possession does not mean the items have no value, but will be a major factor in determining value under the willing seller, willing buyer test. In some cases it will have a negative affect on value and in some possible cases may enhance value. Related to the issue of contraband, see the discussion above regarding "Stolen art objects."

[a] Illegal controlled substances

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 apparently died in attempting to land his plane. It seems that a substantial discount should be available because of the risk in selling an illegal substance. Yet, if the IRS position prevails justice is probably done in preventing the decedent's family from benefiting from the fruits of prior drug trafficking.

In the TAM the IRS went on to take the position that a decedent's estate was not entitled to deduct as a loss under IRC § 2054 (see Schedule L) the value of cash and the fair market value of marijuana that was forfeited under applicable Florida drug enforcement laws because such deduction would have frustrated a sharply defined state and federal public policy against drug trafficking.

[b] Illegality of possession

In *Sammons v. Comm.*, 838 F.2d 330 (9th Cir. 1988), the court said that reasonable reliance on an appraisal avoids the negligence penalty. The case involved the proper income tax charitable deduction allowed on a donation to a museum of a collection of American Indian artifacts containing bald eagle feathers and other parts of protected bird species. Possession of any part of a bald eagle including feathers, regardless of when the initial possession occurred, was prohibited by the Bald Eagle Protection Act, the Migratory Bird Treaty Act, and the Endangered Species Act. The IRS unsuccessfully argued that because it was illegal to possess the artifacts containing bald eagle parts that allowing a charitable deduction would violate public policy. The court rejected that argument and held that the taxpayer had sufficient interest in the collection to allow them to donate it to a museum and take a tax deduction, even though their possession of the feathers and bird parts may have violated federal law. Possible illegality of possession did not prevent them from acquiring or passing title. Also, no evidence was presented that allowance of such deduction would encourage killing or acquisition of protected species.

[c] Cloud on title

Paul Adams, 50 TCM (CCH) 48 (1985), an income tax charitable contribution case, involved the fair market value of an original prototype model of the "Nordon Bombsight," donated to a museum. The Nordon Bombsight was classified military equipment, even though originally developed during World War II. The IRS failed to prove that the taxpayer did not have legal title to the historic item; nevertheless, the court reduced the appraised value because even a slight cloud on title would have a negative effect on the value of the property. As an income tax charitable deduction case, the same as *Sammons v. Comm.*, the IRS argued for a low value and the taxpayer for a high value, but the valuation principles should be the same for income tax as estate tax purposes. Any time there is a question of title as to an estate tax item, particularly one not subject to the marital or the charitable deduction, cite this case.

[14] Crops

This includes both harvested crops 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). Crops receive a step-up in basis and thus avoid income when the crop is sold.

[15] Debts due decedent

Notes and mortgages are listed on Schedule C. Form, Schedule C, p. 13. Schedule F will include loans or accounts not represented by a signed instrument.

[16] 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. Malcolm Moore, *Comment*, PHILIP E. HECKERLING 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.

Your author is in possession of a letter from a financial liquidation service offering to purchase a variety of cash flow notes and income generating assets including inheritances in probate. The letter included this statement, "The next time your client needs to liquidate their cash flow assets, call the seasoned professionals at [Melting Liquidations]. ***Even if your client chooses not to sell, you have the benefit of the best market value there is: a bonafide, written cash offer."***

[17] Farm machinery

The regulations require that farm machinery be itemized and the value of each be separately returned. Treas. Reg. §20.2031-1(b). The beneficiary of the farm machinery will be able to begin depreciation at the new basis of the farm machinery.

[18] Fees, uncollected

A contingent fee received between DOD and AVD must be included in full if the AVD is elected, per *Aldrich Estate v. Comm.*, 1983-543 TCM (1983). Apparently if DOD valuation was elected the fee would be included, based upon the amount

collectable discounted by the possibility of success in collection.

[19] Gemstones

Discussion of gems is included in the discussion of jewelry, below.

[20] Household goods and personal effects

[a] Value

The regulations provide, "[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. For the appraisal requirements where there is an item in excess of $3,000, see the subsection above entitled, "Appraisal required."

[d] General requirements for appraisers

If expert appraisers are employed, either where required or voluntarily, the regulations state "care should 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).

This blurb appeared in the *San Antonio Express-News* on December 22, 2001, p. 20A.

> Phony appraisals
> bring guilty plea
>
> PHILADELPHIA -- An antiques dealer pleaded guilty Friday to staging phony appraisals of Civil War-era artifacts on the PBS program "Antiques Roadshow."
>
> Russell Pritchard III, 38, of Bryn Mawr also pleaded guilty to stealing a uniform from a Civil War museum in Harrisburg, Pa., where he worked, and defrauding Civil War collectors by giving them low appraisals on artifacts, then reselling them at much higher prices.
>
> In one case, Pritchard and his business partner, George Juno, bought military antiques from the family of Confederate Gen. George Pickett for $87,000, then sold them to the Harrisburg museum for $870,000, prosecutors said.

This follow-up blurb appeared in the *San Antonio Express-News* on July 12, 2002.

> Antiques appraiser
> sentenced to prison
>
> PHILADELPHIA -- An antiques dealer was sentenced Thursday to a year in prison and ordered to repay $830,000 for staging phony appraisals on the PBS series "Antiques Roadshow" and defrauding Civil War collectors.
>
> Russell Pritchard III, 39, pleaded guilty to making the bogus TV appraisals. He also admitted defrauding artifact owners by giving them low appraisals on items, then reselling them at much higher prices and pocketing the profit.
>
> According to prosecutors, Pritchard made between $800,000 and $1.5 million on the fraudulent transactions. He could have gotten up to 135 years in prison and more than $5.2 million in fines.

[e] Homeowner's insurance

Homeowner's insurance coverage is an unreliable measure of fair market value, because coverage is usually pegged to the value of the home and may represent replacement cost, rather than the value under the willing buyer-willing seller test.

[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).

[21] Individual retirement accounts

It is not clear from the instructions where individual retirement accounts should be listed. Some preparers list them on Schedule B or Schedule C, depending upon whether IRAs are invested in stocks and bonds or in cash. Other preparers believe they should be listed on Schedule I. Schedule F may be the better place to list IRAs. If the IRA is community property, do not report the interest of the non-participant spouse.

[a] IRAs and alternate valuation

Neither the instructions nor the regulations address how alternate valuation rules apply to IRAs. Treas. Reg. §20.2032-1(c)(2)(ii) states that an asset is distributed when the property becomes unqualifiedly subject to the demand or disposition of the distributee, but that provision of the regulation does not appear to be applicable to IRAs. See the discussion on alternate valuation and assets reported on Schedule E. By analogy, death of the account owner does not itself amount to a disposition. It might also be argued that when the account is retitled in the name of the beneficiary that a disposition has occurred for alternate valuation purposes, but there is no instruction, regulation or ruling clearly stating that result and one could equally argue that retitling is not a disposition. It seems reasonable to your author that the account would be valued based upon the assets in the account: date of death for cash, cash equivalents, bonds and notes and date of disposition or six months for securities. That still leaves open the question of whether the beneficiary making a demand for distribution of assets from the plan is a disposition. It would seem that the point could be argued either way where the beneficiary demands distribution of securities from the account. So too there is no authority on point as to whether the whole account is valued on the six month date when there are individual securities bought and sold within the account during the alternate valuation period. *See also*, Choate, *Estate Tax Valuation of Retirement Benefits*, TRUST AND ESTATES, May 2002, p. 16. Your author believes that the argument in favor of a discount for the income tax on and IRA set forth in Slater-Jansen and Finkelstein, *Easing the Burden on IRA Estate Taxes*, 4/1/2002 NYLJ 9, is unsound.

[22] Insurance renewal commissions

A rule of thumb on valuing a modest stream of renewal commissions with a decrease of 25% each year and the stream ceasing the tenth year after death would be twice the payments received the year before death. Use an appraiser if a substantial stream of renewal commissions are involved.

[23] Intellectual property

Intellectual property rights will include copyrights, patents, trademarks, and trade secrets. For a discussion of valuation issues involved, *see* "Intellectual Property Valuation, Damages, and Open Price Analysis," Reilly and Schweihs, *Insights*, special issue 2004.

[24] 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 *Estate of Lemann v. U.S.*, 73 AFTR2d 94-2345 (E.D. 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 appraisals 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 an estate must value jewelry is the market in which a jeweler would sell the jewelry but a market closed to the estate? To this author, it seems that the IRS penalizes the estate of a decedent owning 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 5, "Automobiles," which indicates that may not be a fair comparison because an estate can

sell an automobile to the general public through a classified ad and the blue book now gives a price for a sale of an automobile to the general public.

Trompeter v. Commissioner, TC Memo 2004-27; No. 11170-95, on remand to the Tax Court from the Ninth Circuit, took a jaundiced view of auction prices as being an indication of fair market value, probably because the taxpayer wanted to use auction prices for assets not reported on the estate tax return and seized from a safe deposit box by the IRS while the IRS as respondent produced uncontroverted testimony of its appraiser. This extensive quote from the case sets forth the reasons that an auction, in the court's view, does not give fair market value for jewelry or gemstones.

> Respondent retained an expert, Charles I. Carmona (Carmona), Graduate Gemologist in Residence, Accredited Senior Appraiser, who, on direct examination, testified through his written report, see Rule 143(f)(1), that he had ascertained the applicable fair market values of 25 of the seized assets (25 seized assets) and that those values were as stated in that report. (We attach hereto as appendix A Carmona's description of each of the 25 seized assets, its appraised value, and, in the case of 19 of the assets sold by Christie's at auction, its auction price.) We considered Carmona to be helpful to our valuations of some of the disputed assets, and we relied on his opinion, which was credible and without contradiction.
>
> Carmona examined and researched each of the 25 seized assets and opined that the fair market value of those assets for Federal estate tax purposes was the "average price that each item in its current (used) condition might resell to the public in its most common retail outlets in the Estate's local area". He opined that the proper resale prices for jewelry were the prices obtained at a retail jewelry store and that the proper resale prices for loose gemstones were their wholesale prices increased by the commissions charged by brokers on their sales of gemstones to the public. He opined that the public usually buys jewelry at retail from jewelry stores that sell estate jewelry, that the majority of buyers at public auctions are dealers, that the lowest level of sales prices for jewelry is found at auction, and that jewelry usually passes from the dealer to the public through retail jewelers with a dealer-to-retail-jeweler markup of 25 to 50 percent over cost and a retail-jeweler-to-public markup of 50 to 100+ percent over cost. He opined that the wholesale prices paid for gemstones by brokers was best ascertained from personal experience and comparable sales and offers to sell. He opined that a broker's commission on a sale of loose gemstones to the public was typically 15 to 25 percent of the wholesale price.
>
> ***
>
> Before Christie's auctioned the 25 seized assets, it had assigned to each of these assets a lower and upper estimated value. (We attach hereto as appendix B a list of each item's lower and upper estimated values, agreed reserve (i.e., the minimum price at which an asset could be sold by Christie's at auction), auction price (in the case of the 19 items sold at auction), high bid (in the case of the six items not sold at auction), and Carmona's appraised value.) These lower and upper estimated values are estimates by Christie's of the likely amounts that bidders would bid at an auction for the assets. These estimated values do not reflect the requirement of Christie's that buyers also pay to Christie's on each sale a commission equal to 15 percent of the first $50,000 of the purchase price and 10 percent of any excess. Nor do the estimates (or the ultimate sales prices) include sales tax that is payable on the sales.
>
> The 25 seized assets consist of 11 items of jewelry and 14 loose gemstones. Of those assets, six items of jewelry and 13 loose gemstones were sold at the action held by Christie's. The remaining six assets (i.e., five items of jewelry and one loose gemstone) did not sell at the auction.
>
> The six items of jewelry sold at auction for a total auction price (exclusive of buyer's commissions) of $79,100. Christie's estimated that these six items had a total lower estimated value of $70,000 and a total upper estimated value of $107,500. Carmona ascertained that the fair market value of these six items totaled $146,200. Carmona's total fair market value for these six items is 84.83 percent (($146,200 - $79,100)/$79,100) greater than the total of their auction prices.
>
> The 13 loose gemstones sold at auction for a total auction price (exclusive of buyer's commissions) of $764,600. Christie's estimated that these 13 gemstones ad a total lower estimated value of $488,000 and a total upper estimated value of $656,000. Carmona ascertained that the fair market value of these 13 gemstones totaled $1,000,000. Carmona's total fair market value for these 13 gemstones is 43.87 percent (($1,000,000 - $764,600)/$764,600) greater than the total of their auction prices.
>
> Christie's estimated that the five items of jewelry which did not sell at auction had a total lower estimated value of $28,000 and a total upper estimated value of $39,500. Carmona ascertained that the fair market value of these five items of jewelry totaled $37,200. Christie's estimated that the one loose gemstone which did not sell at auction had a lower estimated value of $14,000 and an upper estimated value of $16,000. Carmona ascertained that the fair market value of this single gemstone was $9,100.
>
> We find that, as of the applicable valuation date, the fair market value of each of the six

assets which did not sell at auction equaled its fair market value as ascertained by Carmona. In other words, we find that the fair market values of the five items of jewelry which did not sell at auction totaled $37,200 and that the fair market value of the single gemstone that did not sell at auction was $9,100. We find that the individual values of these six assets are as follows: [list omitted]

We consider Carmona to be most helpful to our valuation of each of these six assets. Carmona testified as to jewelry in general that the typical buyer of jewelry at auction is a dealer and that jewelry usually passes from a dealer to the public through retail jewelers with a dealer-to-retail-jeweler markup of 25 to 50 percent over cost and a retail-jeweler-to-public markup of 50 to 100+ percent over cost. As to the six items of jewelry which sold at auction for a total price of $79,100, a markup of that total price by the minimum dealer-to-retailer and retail-jeweler-to-public markups referenced by Carmona (i.e. 25 and 50 percent, respectively) results in a total retail price of $148,312.50 ($79,100 + ($79,100 x .25) = $98,875; $98,875 + (98,875 x .50) = $148,312.50)), or, in other words, approximately the same as the total fair market value of $146,200 ascertained by Carmona for those items.

Carmona testified as to gemstones in general that the public usually buys a gemstone at an amount that equals the gemstone's wholesale price plus 15 to 25 percent of the wholesale price. As to the 13 gemstones which sold at auction for a total price of $764,600, we do not find in the record any persuasive evidence that would indicate whether the auction price of those gemstones represents their wholesale price. We would imagine that, generally speaking, the auction price of a gemstone is at least 15 percent less than its wholesale price. Otherwise, why would a broker/dealer pay a double digit commission at auction (15 percent of the first $50,000, 10 percent thereafter) to buy a gemstone "as is", when the broker/dealer could buy a "similar" gemstone from a wholesaler with the payment of a commission? When we increase the $764,600 total auction price paid for the 13 gemstones by the $95,440 of commissions payable to Christie's on the respective sales, and then mark up the sum of $860,040 ($764,600 + $95,440) to reflect the 15- to 25- percent commissions referenced by Carmona, we arrive at a range of retail value for the gemstones from $989,046 ($860,040 x 1.15) to $1,075,050 ($860,040 x 1.25). This range approximates the $1.1 million total fair market value ascertained by Carmona for the 13 gemstones.

We recognize that none of the six assets in question actually sold at auction for even the lower estimated value ascertained by Christie's. We do not consider any of these lower estimated values to be a proper measure of the price at which a hypothetical willing buyer and a hypothetical willing seller would consummate a sale of those assets. The auction was a single auction that included many precious gemstones and many valuable items of jewelry. The mere fact that each of the six assets offered for sale at the auction did not sell there for even its lower estimated value does not mean under the facts herein that its fair market value is necessarily less than its lower estimated value. *Cf. CTUW Hollingsworth v. Commissioner*, 86 TC 91, 101 (1986) (unaccepted offer to purchase land is not conclusive evidence of the value of the land). We also do not know, for example, whether the bidders at the auction consisted of actual consumers who were willing to buy an item at its fair market value or, as Carmona persuasively opined in the setting of jewelry auctions, primarily dealers who bid substantially less than fair market value in order to resell their purchases at a fair market value price which, to them, would be inclusive of a businessman's profit. In fact, we know little about the composition or number of bidders at the auction, let along the tone of the actual bidding that took place. On the record before us, we simply cannot conclude as to any of the six items in question that the auction market is the "market * * * in which such item is most commonly sold to the public". Sec. 20.2031-1(b), Estate Tax Regs.

We are mindful that this Court has on occasion determined that an item's auction price was its fair market value. E.g., *Estate of Scull v. Commissioner*, TC Memo. 1994-211; *Lightman v. Commissioner*, TC Memo. 1985-315. In contrast with the case at hand, the auction markets in those cases were shown to be the appropriate retail markets for the assets under consideration, and the sales at auction were shown to be to the ultimate consumer. Where as here such is not the case, the Court has rejected equating the auction price of an item with its fair market value. E.g., *McGuire v. Commissioner*, 44 TC 801 (1965) (prices paid at auction for art, furnishings, and other personal property did not reflect fair market value in that the bidders at auctions were generally wholesalers or dealers who were buying for resale); cf. *Stollwerck Chocolate Co. v. Commissioner*, 4 B.T.A. 467, 471 (1926) (auction price determined to be fair market value where evidence established that "There were some twenty buyers present [at the auction], seven or eight of whom made bids for the property."). We also note as to the facts at hand that the auction by Christie's involved assets seized by respondent to satisfy a perceived Federal tax obligation, which, in turn, suggests that the auction at hand had an element of a forced sale. A forced sale is inconsistent with the willing seller requirement of fair market value

and is not probative of fair market value. See, e.g., sec. 20.2031-1(b), Estate Tax Regs.

We are also mindful of Rev. Proc. 65-19, 1965-2 CB 1002. As relevant herein, that revenue procedure applies to "certain items of tangible personal property which, while generally available to a member of the general public at retail establishments, frequently are obtained by members of the general public at a public auction". Under this revenue procedure, the Commissioner presumes for purposes of section 20.2031-1(b), Estate Tax Regs., that the auction price of an item of tangible personal property is its retail sales price. By extension of this presumption, the fair market value of an item of tangible personal property not sold at auction could be presumed to be no greater than its high bid at auction.

We do not believe that the presumption of Rev. Proc. 65- 19, *supra*, applies to set conclusively the fair market value of the six assets in question. Five of those assets are items of jewelry. We find pursuant to Carmona's testimony that the public does not frequently purchase jewelry at auction. As to the sixth item, a loose 18.2-ct. sapphire, we are unable to find in the records that loose sapphires are typically sold to the public at auction. However, even if the presumption were to apply to one or more of these six assets, we conclude from the record that the high bids for those six assets are not reflective of their retail sales price. We bear in mind especially our findings herein as to the much higher prices which the decedent paid to Mamiye and Lloyds for the comparable and other items show on the receipts.

We recognize that respondent stipulated that the applicable values of 19 of the 25 seized assets were the same as their auction prices and that those prices were in most instances lower than Carmona's appraised values. In valuing the assets in dispute, we do not find in the record that respondent has presumed under Rev. Proc. 65-19, 1965-2 CB 1002, that the fair market values of the 19 assets equaled their auction prices. In fact, given that the auction prices stipulated by respondent did not reflect the commissions paid by the buyers, we conclude to the contrary. See *Estate of Scull v. Commissioner*, TC Memo. 1994-211 (when the appropriate retail market for an item is the auction, the fair market value of an auctioned item equals its auction price plus buyer's commission). See generally 2003 Fed. Tax Coordinator 2d (RIA), vol. 21, par. P-6009, at 42,252. More importantly, the fact that these assets sold at auction, presumably to dealers, suggests in this case that respondent's pursuance and the Court's redetermination of a fair market value for any of the 19 assets greater than its auction price would have made little or any difference in the deficiency in that the estate would have been entitled to deduct the additional value as an administration expense. See sec. 20.2053-3(d)(2), Estate Tax Regs.; see also *Estate of Joslyn v. Commissioner*, 566 F.2d (9th Cir. 1977), revg. 63 TC 478 (1975).

The above quote refers to use of auction prices from the sale of items other than the ones in the estate. Rev. Proc, 65-19, 1965-2 CB 1002, provides that a bona fide sale of an item of tangible personal property at a public auction, gives the presumption that the sale price is the retail sales price for the item at the time of the sale. The sale must be made within a reasonable period following the applicable valuation date and there is no substantial change in market conditions or other circumstances affecting the value of similar items between the time of sale and the applicable valuation date. Thus, an actual auction sale for jewelry should establish its fair market value for federal estate tax purposes.

A sale to the public refers to sale to the retail customer who is the ultimate consumer of the property. In *Anselmo v. Comm.*, 757 F.2d 1208, 1214 (11th Cir. 1985) (an income tax case) the valuation of uncut gems was at issue. Retail jewelers were found to be the ultimate consumers of uncut gems, which were consumed in the process of manufacturing items of jewelry.

Are excise taxes to be included in the value? Commentators have stated that the value of jewelry included any excise tax, but without any citation to authority. Schain, *Estate Gift, Trust and Fiduciary Tax Returns*, §6:2[9] (2000). Your author of this article would not include excise tax, just the same as he would not include sales tax on any item.

[25] Judgments

Specific guidance on reporting judgments comes from the regulations.

> Judgments should be described by giving the title of the cause and the name of the court in which rendered, date of judgment, name and address of the judgment debtor, amount of judgment, and rate of interest to which subject, and by stating whether any payments have been made thereon and, if so, when and in what amounts.

Treas. Reg. §20.6018-3(c)(5).

A discount for the uncertainty of collection may be appropriate as well as a discount for the time value of money where there may be a period of time until collection is complete. If the judgment is not otherwise subject to income tax, does valuation at less than the amount actually collected create taxable income on the excess? If these are handled for income tax purposes like mortgage notes, then there will be taxable income on the excess.

[26] Lawsuits

A lawsuit that was not brought to a judgment on the date of death is not necessarily valued at what the ultimate judgment brings. At death, a lawsuit is a chose in action and a judgment remains just a possibility.

"Valuing a lawsuit can be a difficult task." *Estate of Smith v. Comm.*, TC Memo 2001-303 (CCH Dec. 54,548(M)). "[A] lawsuit is not the type of asset, either tangible or intangible, which readily fits within the categories of things regularly traded in commerce." *Estate of Davis v. Comm.*, TC Memo 1993-155 (CCH Dec. 48,975 (M)). The value a plaintiff may have in a lawsuit is not necessarily the converse of the obligation faced by a defendant. "Obviously, the position of a defendant in a pending lawsuit is not a thing commonly bought or sold. There is certainly no ready market in which the Estate could pay another to assume its place as the subject of [plaintiff]'s claim." *Estate of Smith v. Comm.*, 198 F.3d 515 (5th Cir. 1999); AOD 2000-04. That statement should be contrasted with contingent fee cases in which a decedent attorney's interest is in a sense subject to sale to the successor attorney, albeit on a percentage rather than a hard dollar basis.

Estate of Isaac W. Baldwin v. Comm., TC Memo 1961-89, Dec. 24, 741 (M) involved valuing a decedent's lawsuit against his brother and long-time business partner where the decedent during life was reluctant to sue his own brother who dominated him in business and personal matters. The estate argued that the claim was unsalable in the community because of the defendant's reputation for hostility and litigiousness and the court noted that strangers are reluctant to interfere in family squabbles. The court contrasted an estate tax valuation with an income tax valuation issue.

> In income tax cases, the impossibility of realizing any amount approaching intrinsic value or a fair price (i.e., the absence of a "fair market") for an asset received will permit the conclusion that such assets have no fair market value. [citations omitted] In these cases ... when we find no value for the asset received, we are not completely refusing to recognize a gain or loss but are simply postponing such recognition until a time when a more reliable and realistic determination is possible. [citation omitted] However in estate tax cases no such postponement is possible and if the tax is not assessed now on a value determined (however imprecisely), the tax is forever lost. This is a difference which the writers have recognized [citations omitted] and which has been significant in court decisions [citations omitted]. The necessity for determining value here is thus much akin to that involved in eminent domain proceedings.
>
> Furthermore, in such a predicament we are justified in assuming the existence of a "hypothetical market" where imaginary sales might take place. *See Houghton v. Commissioner* [1934 CCH ¶9356], 71 F.2d 656 (C.A. 2, 1934), and cases there cited. The impossibility of marketing a claim does not mean that a valuation will not be made or that the valuation will be zero. It thus strikes us that this is one of those innumerable situations where the finder-of-fact simply is obliged to do the best he can with the evidence available and arrive at a valuation as fair as possible. We cannot, from the evidence, conclude that the claim was valueless (whether or not it had a fair market value). *Id*. 403-404.

Factors making it difficult or impossible to sell a claim will reduce the value of the claim but will not reduce the value to zero.

Marc S. Margulis, in an article entitled *"Valuing a Decedent's Legal Claims, Lawsuits, and Choses in Action"*, in VALUATION STRATEGIES, Jan./Feb. 1998, discusses the unique uncertainties inherent in such assets, and proposes a valuation method using a decision tree analysis that takes into account the claim's procedural alternatives and assesses its various probabilities and outcomes. Margulis suggests that the preparer may need to engage litigators or law professors to assist the valuation expert in making this analysis.

At a minimum, any valuation needs to include a careful analysis of what rights accrue to decedent's estate. A wrongful death action for the death of the decedent is a right of the decedent's spouse, parents or children. In Texas if they do not bring the lawsuit within three calendar months of the decedent's death, then the personal representative of the estate is to bring the lawsuit. See generally "Wrongful Death," 77 Tex. Jur. 3rd §9 *et seq*. Consult the law of the appropriate state. A right that accrues to the spouse, parents or children is not a right that should be included in the decedent's federal gross estate. Even if the action is brought by the personal representative of the estate, it should not be included in the federal gross estate because it is being brought on behalf of the spouse, parents or children and not on behalf of the creditors or the beneficiaries of the estate other than the spouse, parents or children. *Id*. §13. *Connecticut Bank & Trust Company v. US*, 465 F.2d 760 (2nd Cir. 1972), supports the rule of exclusion from the federal gross estate for wrongful death proceeds that are payable to the decedent's estate, in an opinion that focuses upon what the decedent owned at the time of death. At issue was a Connecticut law that provided that the executor or administrator of the estate was to bring the lawsuit for wrongful death and the proceeds were to pass

under the decedent's will and were subject to the claims of creditors.

> The crucial issue to be decided under § 2033 is whether or not the value of an action for wrongful death is "property . . . of the decedent at the time of his death." . . .
>
> Simple logic mandates the conclusion that an action for wrongful death cannot exist until a decedent has died, at which point, he is no longer a person capable of owning any property interests. The Government's reply to this is that at the very instant of death the right of action arose which the decedent was then capable of owning at death. The only authorities cited for this position, however, are cases where preexisting property interests were valued as of the instant of death, but valuation at time of death of prior existing interests is a far different concern from that in this case where the property interest itself has sprung from the fact that the death has taken place.
>
> While it is true that Congress may constitutionally place an excise tax on property created by death, as well as upon property transferred by death, [citations omitted] , § 2033 does not read so broadly. In a discussion of the estate tax the Supreme Court described the scope of § 2033: "What this law taxes is not the interest to which the legatees and devisees succeeded on death, but the interest which ceased by reason of the death," *Y.M.C.A. of Columbus, Ohio v. Davis*, 264 U.S. 47, 50, 44 S.Ct. 291, 292, 68 L.Ed. 558 (1924); *see also, Nichols v. Coolidge*, 274 U.S. 531, 537, 47 S.Ct. 710, 71 L.Ed. 1184 (1927). Where, as here, there was no property interest in the decedent which passed by virtue of his death, but rather one which arose after his death, such an interest is not property owned at death and not part of the gross estate under § 2033, [citations omitted].
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> ***
>
> The Treasury Department has issued three Revenue Rulings concerning the inclusion of wrongful death proceeds under § 2033, all of which hold that the proceeds are not part of the gross estate. . . . In Rev.Rul. 54-19, 1954-1 CB 179, 180, the Department stated: "Inasmuch as the decedent had no right of action or interest in the proceeds at the time of his death, nothing 'passed' from the decedent to the beneficiaries. Accordingly, the amounts recovered by the beneficiaries would not be includible in the decedent's gross estate for Federal estate tax purposes." It held that such proceeds were not part of the gross estate in Rev. Rul. 68-88, 1968-1 CB 397, 398, because "[t]he right of action for wrongful death does not accrue until death occurs," and in Rev. Rul. 69-8, 1969-1 CB 219, because "[t]he decedent in his lifetime never had an interest in either the right of action or the proceeds." See also, Rev.Rul. 55-581, 1955-2 CB 381, holding that an allotment paid by the armed services to designated beneficiaries of service men who die in active duty is not part of the gross estate; and Rev. Rul. 55-87, 1955-1 CB 112, holding that a lump sum payment for federal expenses to social security recipients is not taxable under § 2033.

The court also rejected an effort to include the wrongful death proceeds in the gross estate by treating them as a general power of appointment because of the fact that the proceeds passed according to the decedent's will.

In Rev. Rul. 75-127, 1975-1 CB 297, the IRS announced that it would follow this holding, and cases arising under Iowa law as well.

> Accordingly, the Internal Revenue Service will no longer take the position under Connecticut, Iowa, or Arizona law, or under the law of any State having a wrongful death statute similar to the law of one of these states, that the value of wrongful death proceeds is includible in the decedent's gross estate. However, where it can be established that such proceeds represent damages to which the decedent had become entitled during his lifetime (such as for pain and suffering and medical expenses) rather than damages for his premature death, the value of these amounts will be includible in the decedent's gross estate.

If the decedent had a wrongful death cause of action for the death of another, the cause of action does not survive the death of the decedent, at least in Texas. The laws of other states that give rise to the cause of action need to be consulted to determine whether the cause of action survives the decedent. *See generally* PROSSER ON TORTS, §127 "Actions Under Wrongful Death Statutes." On the other hand, a cause of action for pain and suffering or medical costs is personal to the decedent and becomes the property of the decedent's estate.

Another aspect as to whether the lawsuit is property of the estate or the beneficiaries of the estate is the question of whether a recovery is subject to a superior IRS lien against the estate or whether the recovery belongs to the beneficiary. In *Murphy v. Comptroller*, 2002-2 USTC (D.C. Maryland 2002), the settlement proceeds from two malpractice lawsuits filed against the estate's attorney were subject to the IRS' tax lien against the estate because the proceeds constituted property of the estate and not the beneficiary. The plaintiff in the malpractice action brought suit reflecting his dual capacity as a co-personal representative and primary beneficiary. Maryland, the applicable state, law had a privity rule and the settlement proceeds could only be attributable to plaintiff's claims on behalf of the estate as the personal representative. The proceeds were estate property and subject to the IRS' lien.

Where the lawsuit does survive the death of the decedent and its value is included in the decedent's estate, the death of the decedent and decedent's inability to assist in prosecution of the case is a factor to be considered in valuation of the lawsuit. The extent of completed discovery on the valuation date may increase or decrease value.

Lawsuit valuation will also arise in a situation in which the decedent attorney has lawsuits pending on a contingent fee basis. As noted earlier, such cases are in a sense "sold" to the successor attorney to complete the litigation, but such sales are usually on a percentage fee basis, rather than a hard dollar basis. As such, the valuation issues are not fully answered in the transfer.

In *Estate of Curry v. Comm.*, 74 TC 540 (1980), at issue was the decedent's contractual right to share in contingent legal fees of thirteen Indian claims cases that were pending before the Indian Claims Commission at decedent's death. The fact that the fees were contingent on successes of the individual cases did not prevent decedent's portion of the fees from being included in the decedent's gross estate. The contingent nature of the fees only bore on valuing the decedent's contractual rights.

The fees ultimately received will be IRD to the estate and subject to both estate taxes, on a value included on Schedule F, and income taxes as the amounts are realized. There is the real possibility of a difference in the amount reported on Schedule F and the amount actually received, either over or under the Schedule F reported amount. Do not use the successor attorney as the appraiser because that attorney has an interest in the case. A possibility is to request an opinion from an experienced plaintiff's lawyer as to the claim's settlement value. You might consult with a mediator who settles a substantial number of tort claims. Avoid using a claims adjustor who has either a current or past interest in the insurance company that may be involved in the litigation. Consider using as your valuation expert a defense attorney who is not representing any of the defendants involved in the litigation, but who may have some difficulty escaping his or her defense bias.

[27] Life estates, life of another

See discussion below of *remainder interests.*

[28] Life insurance on life of person other than decedent

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. Schedule D, Form, p. 15. For a policy on a living person, the back side of the Form 712 is completed. The value will be the interpolated terminal reserve of the policy, plus the unearned premium, less any policy loan. Treas. Reg. §20.2031.8(a)(2). If the insured's death is pending then the standard valuation method may not be appropriate and the value may be closer to face. See *Estate of Pritchard v. Comm.*, 4 TC 204 (1944).

> "When the farmer's barn burnt down, the insurance company refused to pay him for the loss, offering instead to build him a new barn. He immediately canceled the policy on his wife." That's said to be the oldest insurance joke of record.
>
> L.M. Boyd

[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, Schedule F, 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 CB 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 includable on the decedent's gross estate, for purposes of IRC § 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 CB 321.

[29] Limited liability companies

While these are like corporations, the preparer is not directed to include them on Schedule B or any other schedule, so they are miscellaneous property included on Schedule F like general and limited partnerships.

[30] Livestock

The regulations require that livestock be itemized and the value of each be separately

returned. Treas. Reg. §20.2031-1(b). Livestock receives a step-up in basis and thus avoids income upon sale.

[31] Lottery prizes

Lottery prizes provide two methods of valuation that can result in substantial differences in value. An estate was entitled to an estate tax refund because the $1.9 million value of the remaining installments of a lottery prize, as determined by the estate's experts, was more reasonable and realistic than the $4 million value of the lottery prize as determined by the IRS under the Treas. Reg. § 20.2031-7 valuation tables. Departure from the use of the regulation valuation table was appropriate, according to the district court, because the tables failed to take into account the absolute lack of liquidity of the prize due to the state's (California) prohibition on the transfer of the proceeds. *Estate of Shackleford v. U.S.*, 84 AFTR2d 99-5902 (E.D.Ca.1999). The appeals court agreed that the statutory restrictions on transfers reduced the fair market value of the right to receive future lottery payments. 262 F.3d 1028 (9th Cir. 2001). *Gribauskas v. Comm.*, 116 TC 142 (2001), did not follow *Schakelford* in the Tax Court and held that the lottery payments were an annuity under IRC § 7520 and thus needed to be valued under the IRC § 7520 valuation tables.

The Second Circuit on appeal, *Estate of Gribauskas v. Comm.*, 342 F.3d 85 (2nd Cir. 2003) held that valuing the decedent's lottery winnings under the tables was erroneous when the taxpayer, as in *Schackleford*, provided what the court determined to be a more realistic and reasonable valuation method. Both of these appeals cases raise the question of considering post-death facts as was at issue in *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929). For an article discussing these cases, as well as others, and proposing a new interpretation of *Ithaca Trust*: that the Supreme Court rejected valuation based on post-death facts but only in the context of valuation determined by actuarial tables, see Gerzog "Actuarial Tables Versus Factually Based Estate Tax Valuation: Ithaca Trust Re-Visited" 38 RPPT J. 745 (2004). But a reading of *Ithaca Trust* indicates such a conclusion can be argued from facts at issue, but not the court's opinion by Justice Holmes. As for the facts, decedent's estate gave a life estate to the spouse (before the marital deduction) with remainder to charity, which was deductible. The spouse died within six months of decedent's death and the estate wanted to value the gift to charity disregarding the spouse's life estate while the government's position was that the interest to charity was to be valued based on the mortality tables as they existed on the date of death. Holmes' decision addressed value more generally.

> The question is whether the amount of the diminution, that is, the length of the postponement, is to be determined by the event as it turned out, of the widow's death within six months, or by mortality tables showing the probabilities as they stood on the day when the testator died. The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. The estate so far as may be is settled as of the date of the testator's death. [citation omitted] The tax is on the act of the testator not on the receipt of property by the legatees. [citations omitted] Therefore the value of the thing to be taxed must be estimated as of the time when the act is done. But the value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. [citation omitted] Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true. [citations omitted] Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife's life interest must be estimated by the mortality tables.

Today, even had the life estate not qualified for the marital deduction, the entire gift to charity could qualify for the charitable deduction by a timely disclaimer by the spouse or by her estate within nine months of the date of death.

The Fifth Circuit held, in *Cook v. Commissioner*, 349 F.3d 850 (5th Cir. 2003), that it was appropriate to value annuity payments from lottery winnings using the annuity tables found in Section 7520. The lottery payments could not be transferred to another party. They had been placed in a limited partnership in which the decedent had a 2% general partnership interest and a 48% limited partnership interest. On the estate tax return, the decedent's interest in the partnership was $1,529,749, an amount computed by an evaluation expert who used the discounted cash flow method and factored a lack of marketability discount. The IRS issued a deficiency notice based on a value of the future lottery payments computed using the annuity tables found in Section 7520 and the Regulations. The IRS reduced the figure from the tables to take into account lack of control, lack of ready market for selling the payments, and restrictions found in the partnership agreement. The Fifth Circuit noted that normally assets are valued at their fair market value, the price at which such asset would change hands between a willing buyer and a willing seller, however, when the asset is a private

annuity, one looks to the annuity valuation tables found in Section 7520 and the Regulations. Application of the annuity tables provides a level of certainty and continuity to the valuation process. The Court found that the significant variance in the valuations performed by three experts supported the need for the standardization offered by the Section 7520 tables. The key holding in *Cook* is that the application of a non-marketability discount is not appropriate for annuities because the limited marketability of annuities has been already factored into the annuity table calculations. Departure from the annuity tables is appropriate only when they produce a result that is unrealistic and unreasonable, and no departure is appropriate when the asset to be valued is the right to receive a certain amount of money annually for a certain term. For decedents' estates with lottery winnings not in the Second, Fifth or Ninth Circuits, one is faced with uncertainty how to value the lottery winnings, but one can be virtually certain of obtaining an adverse ruling from the Tax Court and one must plan to litigate the matter up to the appeals court in the estate's circuit. Those litigation costs need to be considered in the determination of whether the estate tax savings are worth pursuing.

[32] 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, state:

> 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, Schedule F, p. 20.

The instructions further 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 includable 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.

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 and 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 includable 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 have applied to the transfer creating the interest. Form, Schedule F, p. 20.

[b] Passing from decedent

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

[c] Duty of consistency

Estate of Mildred Geraldine Letts v. Comm., 109 TC 290 (1997), 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. This opinion was approved

on appeal, *Estate of Letts v. Comm*. 212 F.3d 600 (11th Cir. 2000).

The Internal Revenue Service in litigation guideline memorandum LGM TL-82, 2000 TNT 121-63, states:

> The language of section 2044, which provides that the value of the gross estate includes the value of property for which a deduction was allowed by reason of section 2056(b)(7) upon its transfer to the decedent, mandates the inclusion of the property in the surviving spouse's estate.

In other words, the operative fact that requires inclusion in the surviving spouse's estate is the property's deduction by the donor spouse, not whether that deduction was proper or improper.

The Service applied the doctrine of the duty of consistency in a technical advice TAM 200407018, in which an estate attempted to take differing positions on whether a work of art was includible in the wife's gross estate after being deducted under the marital deduction on the husband's estate tax return. Husband's estate gave his spouse a life estate in all oil paintings and no marital deduction was claimed for them on the husband's return. The particular painting at issue was believed at that time of the death and administration of his estate to be a pastel, and it passed to the spouse in a life estate under a different provision of the will and a QTIP marital deduction was taken in the husband's estate. Shortly after the wife's death and after the statute of limitations had run on the husband's estate, it was discovered on sale of the painting that it was not a pastel but in fact was an oil, that it should not have been part of the assets for which a marital deduction was taken in the husband's estate and not now included in the wife's federal gross estate. The TAM stated that for the duty of consistency, to apply in a particular case, three elements must be present: (1) a representation by the taxpayer; (2) reliance on the representation by the IRS; and (3) an attempt by the taxpayer, after the statute of limitations on assessment has expired, to change the representation. The Service ruled that that painting must be included in the wife's estate for federal estate tax purposes.

Estate of Posner v. Comm., TC Memo 2004-112, rejected the doctrine of consistency and failed to include in the decedent's gross estate a perceived general power of appointment marital trust established in the predeceased husband's estate. The husband died in 1975 and created a marital trust that was treated as a general power of appointment marital trust qualifying for the marital deduction on his estate tax return. Decedent attempted to disinherit her two daughters by a testamentary power of appointment in favor of her revocable trust that only benefited her son, his family and charities. The daughters brought an action in the probate court that decedent did not have a testamentary general power of appointment and that the marital trust passed to them under their father's residuary estate. The trial court found that decedent had an inter vivos power of appointment which she did not properly exercise. The intermediate appeals court held that she held neither an inter vivos nor a testamentary power of appointment. The estate had filed an estate tax return for decedent that reported the property in the marital trust as included in her gross estate and paid the tax, but then filed a claim for refund. The Tax Court agreed that decedent did not have either an inter vivos nor testamentary power of appointment and the marital deduction was not properly available in the husband's estate. The Tax Court then addressed the duty of consistency which prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the time to assess tax for the earlier year has expired. The duty of consistency may apply if: (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced, and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations. The Service acknowledge that the duty of consistency applies if the inconsistency is a question of fact or a mixed question of fact and law, but does not apply to mutual mistake concerning a pure question of law. The Tax Court found that the inconsistency was a question of law and that the marital trust property is not includable in decedent's gross estate.

[d] Certain QTIP property not included

A QTIP election will be treated as null and void for purposes of IRC § 2044(a) when the election was not necessary to reduce the estate tax liability to zero on the pre-deceased spouse's estate. Rev. Proc. 2001-38; 2001-24 IRB 1335. The surviving spouse also will not be treated as the transferor of the property for generation-skipping transfer tax purposes under IRC § 2652(a). The surviving spouse's estate must produce sufficient evidence that the election is within the scope of the revenue procedure, by providing a copy of the Form 706 filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero. This revenue procedure does not apply to (i) situations in which a partial QTIP election was required for a trust to reduce the estate tax liability and the executor made the election for more trust property than was necessary to reduce the estate tax liability to zero; (ii) elections that are stated in terms of a formula designed to reduce the estate tax to zero; or (iii) protective elections under

Treas. Reg. §20.2056(v)-7(c). PLR 200219033 denied the relief under the revenue procedure where some QTIP election was needed. TAM 158073, PLR 200223020, accepted supplemental information to be filed with respect to the first to die's estate tax return but during the surviving spouse's life. In PLR 200407016 during the surviving spouse's life a ruling was requested and granted that an unnecessary QTIP election had been made on the decedent's estate tax return. The procedure set forth in the ruling was for a supplemental estate tax return to be filed with the IRS listing on Schedule M for only those assets that passed outright to the spouse under the decedent's will and a copy of the private ruling attached to the supplemental return.

[e] Recovery of taxes

Unless the person receiving the property (the surviving spouse's) will directs otherwise, the estate may recover from the person receiving the property, the estate tax and any penalties and interest paid on those taxes attributable to inclusion of the Section 2044 property. IRC § 2207A. The amount that can be recovered is the amount by which the total estate tax exceeds the total estate tax that would have been payable if the value of the Section 2044 property had not been included in the gross estate. *Id.* This right of recovery is an interest in property that the residuary beneficiaries under the decedent's will can disclaim.

The regulations under IRC § 2207A defined the "person receiving the property" as the trustee if the property is in trust at the time of the transfer. Treas. Reg. §252207A-I(e). which here would be the date of the decedent's death. Any person who has received a distribution property from the trust prior to expiration of the right of recovery is also a person receiving the property. Because of potential liability for interest and penalties under IRC § 2207A(d), the person receiving the property will want to take affirmative steps, possibly even direct payment, even though this section being termed a right of recovery, implies that the executor pays the tax and then collections from the person receiving the property.

[f] Aggregation

For a discussion of aggregation of Section 2044 property with other property included in decedent's estate and the consequence for valuation discounts see Schedule B's discussion.

[33] Musical instruments

With musical instruments, as with all fine collectibles, be wary where the appraiser is also going to be the purchaser of the item. If the appraiser is the buyer, the executors cannot be certain they receive full value for the item. A low appraisal is desirable for Form 706 purposes but not for sale purposes. Remember the fraud practiced by the dealers in The Red Violin? Here is George N. Gingold, executor of the estate of Josef Gingold, renowned violin instructor at the Indiana University School of Music, upon settlement of a lawsuit alleging fraud, misrepresentation, and unjust enrichment against the dealer engaged to sell Gingold's Stradivari violin:

> "The experts who evaluate and authenticate these instruments are few and a close knit group. They are the very dealers to buy, sell and repair the instruments, and have a potential conflict of interest in dealing with musicians."

The Strad, Nov. 2001, p. 1193.

This problem may be particularly acute with the violin market.

> [A] few world-class dealers now wielded enormous power over the marketplace, playing multiple and potentially clashing roles as buyer, seller, investor, broker, appraiser, wholesaler and retailer.
>
> In larger arenas, such as art or antiques, an individual does not typically hold all these positions. Instead, independent appraisers, for example, have no stake in the items they assess and therefore can offer disinterested appraisals.
>
> In the arcane world of rare violins, however, the powerhouse dealers conduct all these functions, which gives them control of both the flow and the prices of antique instruments. They generally provide expert appraisals to a seller who has no other way to determine the true market value of an instrument.

Howard Reich and William Gaines, "Dealers gain collector's trust, score multimillion bonanza," *Chicago Tribune*, June 17, 2001.

[34] Name, voice, signature, and likeness

Texas Property Code §26 *et seq*. gives an individual a property right in the use of the individual's name, voice, signature, photograph, or likeness after the death of the individual and permits transfer before or after death by contract, trust or testamentary documents. Presumably the transfer by testamentary document can be a specific gift of all or part of the rights, or they can pass under a general residuary clause. If there is no transfer before or at death, then the property right vests (i) all in the surviving spouse if there are no children or grandchildren; (ii) half in the surviving spouse and half in any children and grandchildren, *per stirpes*; (iii) if no surviving spouse, all in the children and grandchildren, per stirpes; (iv) and if no surviving spouse and no children or grandchildren, then equally in the surviving parents. Does this property interest, if not transferred during life, have a value that is included in the gross estate? These rights may be of substantial value in the estate of an entertainer, sports figure, artist, or business person. Despite all

of the famous persons who have died and for whom an estate tax return has been filed, the IRS has not asserted that a decedent's name, voice, signature, photograph, or likeness has a value, at least in any private letter ruling, revenue ruling or court case where the rights were not the subject of a contract during life.

A name was assigned a value in *V. Andrews Estate v. Comm.*, 94-1 USTC ¶60,170 (D.C. Va. 1994). The value of the name of a deceased internationally known, best-selling author was established in part on a publishing contract signed by the author several weeks before death. It was appropriate to consider the publishing contract in determining the value of the author's name because the contract's existence and the possibilities that it presented would be known on the date of death to a hypothetical willing buyer and willing seller. This case suggests that if there was no contract that the value of the author's name need not be included in the estate because its value would be too speculative. Be careful when a famous decedent enters into a contract before death, because there may be a value placed upon the name, voice, signature or likeness, when there would be no need to report a value had the contract been entered after death.

[35] 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).

> It's a carpet if it's bigger than 6 by 9 feet, a rug if smaller: That's not everybody's definition, but some use it.
>
> L. M. Boyd Revisited

[36] Paintings

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

In *Estate of Robert Scull*, 67 TCM (CCH) 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.

[37] Partnership interest

All partnership interests should be reported on Schedule F unless the partnership interest itself is jointly owned, in which case it is properly reported on Schedule E. Form, p. 20. See additional discussion above, "Business Interests, unincorporated."

> At thirty three, Steven Martin formed one of the most extensive collections of nineteenth and early twentieth century American art in existence…. The collection consists of over one hundred twenty major works….The collection was to be shown at the Metropolitan in the winter of this year, but Martin withdrew the offer suddenly….[T]he collection may not be seen…only with Martin's peculiar stipulation that they be hung not according to artist or period, but by weight, with classifications of lightweights, middleweights and heavyweights. Martin is convinced that weight and smell are the only proper study of pictures and all too often is the nose ignored in evaluating works of art. He often takes a picture in hand and lifts it about, then smells every segment of the canvas.
>
> S. Martin, *Cruel Shoes,* 37-39 (1980) Warner Books Edition

Say that you must value a private equity, non-family limited partnership, in which the general partner has the authority to call for additional capital contributions over a period of years. For valuation purposes, how does one properly treat the capital commitment? One approach would be to treat the capital commitment as a liability of the decedent reported on Schedule K, with the aggregate commitment treated as a receivable in valuing the partnership's net asset value. After discounts are applied to the partnership interest, while the liability is fully deducted, a net decrease in the value occurs. Another approach would be to not treat the commitment as a liability separately deducted, but rather as a factor reducing the value of the interest. The notions underlying this approach would be that a full deduction for the liability is inappropriate where the call is potential, not certain and that a willing buyer would not want to be required to make further investment in an asset underperforming at the time of the capital call. After the Tax Reform Act of 1986 and the collapse of the real estate market in Texas, your author reported several partnerships with capital calls on real estate investments on Schedule F with zero or even negative values. See "[E] Closely held business interests during administration," in "§ 6.07 Stock in Closely Held Corporations," in Chapter 6.

[38] Patents

The value of a patent will depend upon the remaining term after the decedent's death. The value of a patent that is pending on the date of death may be highly speculative and nearly impossible to value, because until the patent is issued it will be unclear what the scope of the patent will be.

In Notice 2004-7, 2004-3 IRB 1, the Service stated that some taxpayers are claiming excessive charitable contribution deductions for donations of patents and other intellectual property and said that the Service had seen inadequate substantiation of the

contribution and overvaluation of the intellectual property transferred. In seeking a charitable deduction on income taxes, the taxpayer will seek a high value and the Service will be concerned about overvaluation, while in reporting a patent on a federal estate tax return, the executor will seek a low value and the executor's interests are aligned with that of the Service in the charitable contribution context. There may be difficulty in determining the value of intellectual property, Stokeld "Putting Price Tag on Intellectual Property Difficult, Practitioners Say," Tax Analysts, Jan 20, 2004.

[a] Alternate valuation of patents

The regulations illustrate the alternate valuation of a patent. Assuming that the decedent owned a patent that on the date of death had an unexpired term of 10 years and a value of $78,000 and assuming that six months after the date of death the patent was sold for $60,000, the alternate valuation is obtained by dividing $60,000 by 0.95, which is the ratio of the remaining life of the patent at the alternate valuation date to the remaining life of the patent at the date of the decedent's death, or $63,157.89. Treas. Reg. §20.2032-1(f)(2). The alternate valuation value would presumably include any royalty payments made for the period between the DOD and the AVD, although the regulation does not state that.

[39] Professional practices

Professional practices present unusual valuation issues dissimilar to valuation issues in non-professional businesses.

[a] Legal practices

Legal practices may have value based upon accounts receivable, the office furniture and equipment, and the cases pending upon the decedent's death. Your author is familiar with an estate in which the decedent was a lawsuit broker. He would file the lawsuits and then "sell" them to other attorneys to try them for a portion of the contingent fee when the case settled or was tried. The cases brokered were found by checking the computer at the courthouse for cases that he filed. The date of death value of untried and unsettled cases may be highly speculative. Personal injury cases have a short shelf life, in that upon the lawyer's death the client may be free to take the case to another attorney and will. The executor of the estate must act quickly to obtain the maximum value by "selling" the case to another attorney. There may be some value to legal files or pending matters of a transactional lawyer or estate planning lawyer, but only what can be obtained soon after death by a sale of the files to another lawyer. Here, too, any value to the files will decrease quickly and substantially as time passes after the decedent's death.

[b] Medical practices

A medical practice is worth what you can obtain selling the assets of the practice. Cash has the value of cash and equipment and furniture will have the value of used equipment and furniture. Medical records can have some value, depending on the likelihood of the patients staying with the buying physician, which will depend upon market factors such as what other choices are there for the patients. In a city there may be numerous choices, but in a small market the choices may be limited and there may be value to the records. There will be value to the accounts receivable, but a buyer will normally request a discount for collection. As time passes between the date of death and the actual sale, the value of the medical records and accounts receivable will quickly and substantially decrease in value to worthless. No goodwill attached to a solo medical practice needs to be valued on the Form 706 because the patients will find new doctors. Goodwill only appears where there were partners. An appraiser using the income approach will find a value that is substantially more than for what the practice of a decedent can be sold. Also, the practice of a deceased physician is not to be valued based upon a sale of an ongoing practice of a living physician, because the practice of a decedent cannot be sold for the price of a practice of a living physician.

[40] Real estate in sole proprietorship

Real estate owned by a sole proprietorship is properly reported on Schedule F, not Schedule A, but it is to be reported with the same detail required for Schedule A. Form, p. 20. It is your author's view that the IRS wants such property listed on Schedule F as part of a business so goodwill may be part of the valuation, whereas on Schedule A, real estate valuations do not include goodwill.

[41] Refunds, general

The decedent's estate will be entitled to refunds on most any prepaid good or service, such as magazines, newspapers, cable TV, casualty insurance, disability or medical insurance, and returned merchandise. The author is familiar with an estate in which thousands of dollars of unopened merchandise purchased through magazine sweepstakes and TV-home shopping were returned for refunds.

Many times a refund on casualty insurance on the residence is not reported as an asset, because the insurance coverage continues during the period of administration. The proper way to report such prepaid insurance would be to list on Schedule F the value of the prepaid insurance as of the date of death

and then list on Schedule J the amount of insurance premiums incurred for the period of administration. Because this creates a wash typically the prepaid insurance is disregarded both as an asset and an expense of administration, even though it should be reported as an asset and a corresponding expense.

[42] Remainder interests

Remainder interests, life estates (based upon the life of another) and similar interests are valued by the use of standard or special IRC § 7520 actuarial factors, as provided in Treas. Reg. §20.2031-7(d). IRS Publications 1457 through 1459 provide the applicable rules and factors. In valuing a remainder subject to an inter vivos life estate, the gift tax counterpart of Treas. Reg. § 20.2031-7 is Treas. Reg. § 25.2512-5.

[a] Alternate valuation

If the alternate valuation method is used, the values of remainder interests, life estates and similar interests are figured using the methods proscribed in Treas. Reg. §20.2031-7(d) 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.6; Treas. Reg. §20-2032-1(f)(l).

> "Don't go around saying the world owes you a living. The world owes you nothing. It was here first."
>
> Mark Twain

[43] Salary

Salary, wages, deferred compensation, bonuses and any form of compensation for personal services rendered during life and unpaid at the time of death are included in the gross estate at the full amount that would be included in adjusted gross income for federal income tax purposes. Insurance premiums, FICA, and other deductions other than for savings plans should be deductible as debts. Taxes for income realized before death will effectively be deductible, but income realized after death is IRD and does not receive a discount for future income tax. Deferred compensation or bonuses not subject to immediate payment or payment before filing of the estate tax return may be subject to discount for the time value of money and for the uncertainty of payment. For salary checks issued before death, but unnegotiated at death, see the section above "Checks unnegotiated."

[44] Silverware

When an appraisal is involved, the regulations, Treas. Reg. §20.2031-6(d) provide special rules for silverware. "Sets of silverware shall be listed in separate groups. Groups or individual pieces of silverware shall be weighed and weights given in troy ounces." The regulations continue, "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.

[45] Stock options

As stated earlier, 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 Schedule F. See the section entitled "Stock options," in "Chapter 6, Schedule B, Stocks and Bonds."

[46] 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, 432 (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.

[47] Trust funds, shares in

The instructions request that a copy of the trust instrument be attached. Form, p. 20. Question 12b, Part 4, and its instructions say that Schedule F is to report any trust under which the decedent possessed any power, beneficial interest, or trusteeship. Form p. 3, Instructions p. 11.

[48] Wearing apparel

Except for the most notable celebrities, your author questions whether there is a value to used wearing apparel (other than jewelry and furs) which must be reported.

[a] Non-taxable estate

In a non-taxable estate, the surviving spouse may benefit by a high value on the Form 706, which then turns into a significant charitable contribution deduction on the survivor's Form 1040. The survivor receives the decedent's holding period so the Form 1040 deduction is its value on the Form 706. A Form 8283 must be completed to get the deduction on the Form 1040 if the deduction exceeds $500.

[b] Taxable estate

Where a reported value on Form 706 for wearing apparel will result in increased estate taxes, not reporting the wearing apparel should not be a problem. Examiners are cautioned to not be overly concerned if clothing is not separately mentioned on Schedule F. Examiner's Handbook, (11) 22 (1). One might ask, "Isn't there a value to wearing apparel as indicated by the fact that it is deducted on the Form 1040 when donated to charity?" The value deducted on the Form 1040 is to be what you can receive for the item selling it second hand, such as a garage sale or at a flea market. In the author's experience the full cost of running such a sale results in no net profit. Celebrities may be an exception.

[c] Costumes and sports memorabilia

Special costumes of a performer or sports apparel of a professional athlete may have significant value that should properly be reported on Schedule F.

[d] IRS inquiries

The next time you think the IRS does not have a brain or a heart, consider the following guidance:

> There is little to be gained by inquiring into such items [clothing]; on the contrary, needless antagonism may be generated by such personal probes.
>
> [W]hen considering the value of clothing and personal effects, the examiner must exercise judgment and maintain a sense of propriety.

Examiner's Handbook (11) 22 (1) & (2).

§9.03 *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:

1. examiner's knowledge of decedent's social standing in the community;
2. inspection of the residence and its furnishings, if still intact and undistributed;
3. submitted appraisals;
4. personal property tax assessment sheets in States having a personal property tax;
5. inspection of insurance policies covering household goods, including endorsements for valuable items (this may give an indication of total value);
6. 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;
7. if household furnishings have been sold, a complete listing with sales prices will usually be obtainable;
8. decedent's home and furnishings may have been described and photographed in a magazine or in the local newspaper;
9. decedent's will may mention specific items of household goods, such as antique furniture, objects of art, silverware, etc.
10. probate court files may disclose a complete list of household goods;
11. 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;
12. 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.

10 SCHEDULE G - TRANSFERS DURING DECEDENT'S LIFE

§10.01 *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, Form p. 3.

"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?"

§10.02 *Information reported*

The instructions are extensive on the items that must be reported on Schedule G, including:

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

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

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

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

(v) Revocable transfers, Section 2038.

[A] Certain gift taxes, IRC § 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.

This gross up on taxes for gifts made within 3 years of death takes back the advantage for taxable gifts paying tax on a tax exclusive basis, while estates pay tax based on a tax inclusive calculation.

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 May 15, 2003, gift taxes attributable to gifts made before May 16, 2000, are not includable in the gross estate. 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. Instructions, p. 13. TAM 200432016 followed this type of calculation of the three years, advising that the date of death is the last day of the three year period.

An explanation of how the includable 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. 13.

In TAM 9729005, the IRS ruled that for purposes of IRC § 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 Joseph Cidulka v. Comm.*, TC Memo 1996-149. Could an agreement be made that the spouse's obligation comes back on Schedule G, but is also deductible on Schedule M.?

Gift taxes on gifts made within three years of the date of death by the decedent's spouse may need to be brought back into the estate if the decedent made gifts to the spouse to permit her to make a gift and pay the gift tax. For a case where bad facts helped the IRS make a case that the husband used his wife as a conduit to pay gift taxes, *see Brown v. U.S.*, 88 AFTR2d Par. 2001-5500.

Some time after the estate tax return was filed, the IRS concluded that Willet's estate owed taxes resulting from a pre-death transaction with Betty in which Willet and his advisors created an insurance trust to purchase and hold life insurance on Betty's life, presumably for the purpose of paying estate taxes upon her death. Because Betty had no significant assets of her own, Willet gave Betty a gift of approximately $3,100,000 which was deposited into Betty's separate checking account. With those funds, Betty in turn wrote a check on her account for $3,100,000 and donated it to the insurance trust which used the funds to buy a $10 million insurance policy on Betty's life.

> The gift to the trust was a taxable event. Because gift taxes paid by a donor within three years of the donor's death are included in the donor's estate, Willet and his advisor devised a strategy for having Betty pay the gift taxes, making, in their terms, an "actuarial bet" that it was more probable that Betty would survive three years than would Willet. Thus, Willet made a second transfer of funds to Betty in the amount of $1,415,732, which she in turn used to pay the gift taxes. Some months after these actions were consummated, Willet died.

Some of these bad facts were created before death: (i) the gift checks to Betty being the exact amounts of the gift and the gift tax, (ii) Willet creating the insurance trust rather than Betty, and (iii) the apparent immediate writing of the gift and gift tax checks after receipt of the gift checks from Willet. But, the "actuarial bet" by Willet and his advisors appears to be a fact developed after Willet's death. If presented with a similar set of facts, your author probably would advise the executor to not include the gift taxes in the gross estate. The bad facts make one wonder to what extent the advisors adeptly handled the refund case for the estate tax deficiency the estate paid. Affirmed 2003-1 USTC ¶60,462 (9th Cir. 2003).

In the event of a net gift, where the donee pays the gift tax within three years of the date of decedent's death, the tax is brought back into the decedent's estate. *Estate of Sachs v. Comm.*, 88 TC 769, 778 (1987) ("As donor of a net gift, [decedent] may be deemed to have paid the tax by ordering the donee to pay it over to the Internal Revenue Service on his behalf in satisfaction of his gift tax liability."), *aff'd.* 856 F.2d 1158 (8th Cir.) 1988.

Consider a situation where the decedent made an inter vivos net gift under which the donee agreed to pay the gift tax and any estate taxes resulting from the IRC § 2035(b) gross up for gift taxes if the donor dies within three years of the gift. Decedent dies within three years of gift and leaves the estate to persons other than the inter vivos donee. Are the amount of estate taxes payable by the inter vivos donee included in the gross estate as an estate asset? To the author, this appears to be an estate tax apportionment scheme and does not result in an asset in the gross estate.

[B] Certain transfers within 3 years before death, IRC § 2035(a)

[1] Transfers of insurance

Include any transfer by the decedent with respect to a life insurance policy on a decedent's life within three years before death,

> If
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section …2042 [proceeds of life insurance] if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.
>
> IRC § 2035(a)

The absolute nature of this is somewhat modified by the IRC § 2035(d) that the above inclusion does not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

In TAM 200432015 the Service advised that a life insurance policy on the decedent's life and transferred to an LLC within three years of death in exchange for an interest in the LLC did not qualify as a bona fide sale for an adequate and full consideration. The decedent transferred the life insurance policy and the cash surrender value was initially credited entirely to decedent's capital account. Subsequently, the value was credited one-half to the spouse's capital account as were one half of decedent's other contributions. The decedent subsequently gifted his entire interest in the LLC to his children. The TAM addressed whether the policy proceeds are includable in the decedent's gross estate, and concluded that the entire amount of the policy proceeds were includable in decedent's gross estate pursuant to IRC § 2035(a), because the decedent's inter vivos transfer of the policy to the LLC was a substitute for a testamentary transfer, rather than a bona fide sale for adequate and full consideration in money or money's worth as provided in IRC § 2035(d). Within three years of his death the decedent divested himself of the policy and received no consideration for the transfers, resulting in the entire amount of the proceeds payable on the policy being includable, according to the TAM.

A similar result was reached in PLR 200409010 in which the Service stated that the proceeds would be excluded from the estate under IRC § 2035 (d) if the policy was transferred in a bona fide sale for adequate and full consideration, but that the bona fide sale exception requires a good faith, arm's length transaction and there was no negotiating in this instance among the parties. The limited liability company interest received was not adequate and full consideration. The Service went on to hold the since the policy proceeds were payable to the limited liability company and not to the spouse, the deemed gift of the one half policy to the spouse did not qualify under IRC § 2056 for the marital deduction.

[a] Insurance on decedent

For insurance on the life of decedent, the amount includable and the information required are determined using the instructions to Schedule D. Forms 712 are attached. *Id.*

[b] Group-term insurance

The IRS recognized the proper assignment of yearly renewable group term life insurance. Rev. Rul. 69-54, 1969-1 CB 221, modifying Rev. Rul. 68-334, 1968-1 CB 403 and modified by Rev. Rul. 69-54, 1969-1 CB 221. The master policy will control when a conflict exists between the master policy and an individual group certificate as to whether the group policy can be assigned. *Estate of Gorby v. Commissioner*, 53 TC 80 (1969), *acq*. 1970-1 CB xvi. An assignment prohibited by the master policy will be invalid. *Estate of Bartlett v. Commissioner*, 54 TC 1590 (1970). A proper assignment made before three years before the decedent's death will avoid inclusion in the insured's estate under IRC § 2035. Annually renewable term insurance transferred more than three years before death should not be considered as transferred annually and thus is not included in the decedent's estate. Rev. Rul. 82-13, 1982-1 CB 52. In the instance of an employee's assignment within three years of death necessitated by the employer's change of insurance carrier, the proceeds should not be included in the employee's gross estate under IRC § 2035, provided the prior policy had been assigned more than three years before death, the new policy is identical in all relevant respects and the assignment was made in accordance with the terms of a previous policy. Rev. Rul. 80-289, 1980-2 CB 270. An increase in the amount of the coverage may require inclusion of the excess. *American National Bank and Trust Company v. United States*, 87-1 USTC ¶13,709 (N.D. Ill. 1987).

[c] Insurance on life of another

The Instructions as they relate to IRC § 2035(a) are perplexing when they state that IRC § 2035(a) transfers within three years of death include "Any transfer by the decedent with respect to a life insurance policy within 3 years before death." Instructions, p.13. This is not limited to insurance on

the decedent's life, and the Instructions go on to say as to the amount includible and the information required, "For insurance on the life of another us[e] the instructions to Schedule F. (Attach Form 712)." This clearly implies, if not actually states, that insurance on the life of another is subject to the three year rule. But, IRC § 2035(a) refers to transfers subject to IRC § 2042, but that section only applies to insurance on the life of decedent. To the extent that the instruction would include insurance on the life of one other than the decedent, the instruction incorrectly applies the statute.

[d] Insurance transferred by annual exclusion gifts

IRC § 2035(a) clearly reads that a policy on the life of the decedent transferred to another person when that transfer is covered by gift tax annual exclusion, comes back into the decedent's estate when the transfer was less than three years from the date of decedent's death. Whether the transfer was taxable or tax free makes no difference. If the transfer was to the decedent's spouse and the spouse still has the policy on the date of death, then the inclusion on Schedule G will be offset by an equal deduction on Schedule M.

[e] Transfers within three years to spouse

Consider the tax consequences of a gift of a life insurance policy by decedent to his spouse within three years of decedent's death. The lifetime transfer need not be reported as a taxable gift because of the gift tax marital deduction. The proceeds should be reported on Schedule G, and if the spouse receives the proceeds, they can also be listed on Schedule M. But if prior to decedent's death, the spouse gifts the policy to her daughter, that may be a taxable gift by the spouse to the extent it exceeds the gift tax annual exclusion. But, the marital deduction on the estate tax return may be one of timing. Can it be said that the asset passed from the decedent to the spouse, as required for the marital deduction? Possibly the marital deduction does not cover this once the spouse makes a subsequent gift within three years of death. As far as the author can tell, there is no authority either way that addresses this type of situation.

In TAM 200432015 the Service advised that a life insurance policy on decedent's life, transferred to an LLC within three years of death did not qualify in whole or in part for the marital deduction. Decedent contributed a life insurance policy on his life with a cash surrender value. Decedent and his spouse contributed cash that same year and they contributed cash and bonds the next year. The percentage contributed by decedent was greater than that contributed by the spouse, yet all assets contributed were credited one-half to decedent's capital account and one-half to the spouse's, except the cash surrender value of the policy was initially credited entirely to decedent's capital account and subsequently one-half was credited to the spouse's capital account. The decedent sent a letter to the LLC stating that an application to transfer ownership of the policy was being made and the beneficiary was changed from the spouse to the company. Decedent transferred his entire interest in the LLC to his children and then died. The TAM first concluded that that the entire amount of the policy proceeds were includable in the decedent's gross estate pursuant to IRC § 2035(a), but then concluded that decedent's estate was not entitled to the estate tax marital deduction under IRC § 2056(a) with respect to the proceeds because the proceeds were payable to the LLC. The requirement that the property pass to the surviving spouse was not satisfied in this case and decedent's estate offered no arguments to the contrary. Decedent's estate was not entitled to the estate tax marital deduction under IRC § 2056 for any portion of the proceeds payable to the LLC.

For a similar result on the marital deduction see PLR 200409010, discussed above in the subsection entitled "Transfers of insurance".

[2] Other transfers

Any transfer within 3 years before death of a retained IRC § 2036 life estate, IRC § 2037 reversionary interest, or IRC § 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. *Id.*

[a] 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 includable and the information required are set forth below in the following descriptions for IRS Sections 2036, 2037, and 2038. *Id.*

[b] Excluded transfers

The IRS previously 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. Instructions, p. 11. IRC § 2035(e).

[c] Commutation ineffective

A decedent's gross estate included the entire corpus of a grantor retained income trust (GRIT) under IRC § 2035, even though prior to death the

decedent's interest in the GRIT was commuted by the trustee in distributing the actuarial value of the income interest, as determined under Treas. Reg. §25.2512-5 valuation tables. The IRS ruled that the amount paid to the decedent was only a fraction of the value of the entire interest subject to inclusion in her gross estate under IRC § 2036 and, therefore, did not constitute full and adequate consideration for purposes of the IRC § 2035 bona fide sale exception. TAM 199935003.

[C] Transfers with retained life estate, IRC § 2036

[1] Included transfers

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

(1) The right to income from the transferred property.

(2) The right to possession or enjoyment of the property.

(3) 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. 14.

[2] Amount included

"The amount includable 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 includable in the gross estate is a corresponding part of the entire value of the property." Instructions, p. 14. The actuarial value of a life interest held by another may be subtracted from the otherwise includable amount. Treas. Reg. §20.2036-1(a).

[3] 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 includable in the mother's estate even if the agreement would not have been legally enforceable.
> Instructions, p. 14.

See discussion of "Sales and leasebacks" below.

[4] Implied agreement

The IRS may claim that there is an "implied agreement" that the property can continue to be used. In *R. Wineman Estate*, 79 TCM (CCH) 2189 (2000) the tax court held that minority interests in decedent's homestead property transferred to her children were not included in decedent's estate under IRC § 2036 because the facts indicated that there was not an implied agreement giving the decedent continued possession and enjoyment of the entire homestead property. The decedent continued to use and possess the property, but she used less than all of the transferred property, she shared possession of the property with one of her children, and she did not pay property taxes and other property expenses.

The IRS maintains that where a residence is conveyed to a donor's children or person(s) other than donor's spouse and the donor continued to occupy the residence until death, the property be included in the donor's gross estate at its full value as stated in Rev. Rul. 78-409, 1978-2 CB 234. Continued occupancy after the transfer can be taken as evidence of an agreement or understanding as to retained possession or enjoyment by the donor, according to Rev. Rul. 70-155, 1970-1 CB 189. Even though the agreement may not be set forth in the conveyance instrument and moreover may not be legally enforceable by the donor, the cases support the IRS position. *Guynn v. U.S.*, 71-1 USTC ¶12,742 (4th Cir. 1971); *Linderme Estate v. Comm.* 52 TC 305 (1969); *Estate of Peck v. U.S.*, 65-2 USTC ¶12,333 (D.C. Ga. 1965); *Estate of F. Honigman v. Comm.*, 66 TC 1080; *Estate of Douglas v. Comm.*, 32 TCM 5 (1973); *Whitt Estate v. Comm.*, 85-1 USTC ¶13,607 (11th Cir. 1985).

An individual's gratuitous transfer of her residence to an irrevocable trust, while impliedly retaining possession and enjoyment of the residence, was sufficient to cause the residence to be included in the donor's gross estate under IRC § 2036 in *Estate of Trotter v. Comm.*, TC Memo. 2001-250. The Tax Court found an implied understanding that the decedent would retain possession or enjoyment of the residence, noting factors found by other courts and applicable here: (i) continued exclusive possession by the donor and the withholding of possession from the donee; (ii) donor's occupancy occurred without payment of rent to the donee; (iii) payment of occupancy expenses such as utilities, taxes, and insurance are not being considered a substitute for rent; and (iv) the lack of efforts on the part of a donee to sell, lease, use, or otherwise take steps to obtain any economic return from the property. Factors particular to this case were decedent's husband had a right to possess the

property for a period following decedent's death and that the trust was funded solely with a single piece of real estate that made any attempt to exercise Crummey withdrawal rights complex and burdensome.

An implied agreement was found in the family limited partnership case of *Turner v. Comm*, No. 03-3173 (3rd Cir. 2004), affirming *Estate of Thompson v. Comm*, TC Memo 2002-246, holding IRC § 2036(a) applicable after finding decedent retained lifetime control and enjoyment of the transferred assets and concluding the transfer of assets was not a bona fide sale for adequate and full consideration. Both courts found an implied agreement existed at the time of decedent's transfer of assets that the decedent would retain lifetime enjoyment and economic benefit of the transferred assets. Facts supporting the implied agreement included the fact that decedent parted with almost all of his wealth and did not retain sufficient assets to cover decedent's fixed annual expenses, that his children sought assurances from financial advisors that decedent would be able to withdraw assets from the partnerships to make gifts to family members, and that the partnerships in fact made such distributions to decedent.

[5] Domestic asset protection trusts

Currently six sates have now enacted domestic asset protection trust (DAPT) statutes: Alaska, Delaware, Nevada, Rhode Island, Utah, and Oklahoma, and a decedent who was a grantor during life of such a DAPT should not have the DAPT included in the decedent's estate under IRC § 2036(a)(1). Rev. Rul. 2004-64, 2004-27 IRB 7, discussed whether the trustee's reimbursement of the settlor for income tax that the settlor paid on the trust income constituted "the possession or enjoyment of, or the right to the income from" the trust assets so that the value of those assets would be included in the settlor's gross estate under IRC § 2036(a)(1). Three situations were considered: (1) no state law or governing instrument provision requiring or permitting the trustee to reimburse the settlor; (2) a governing instrument provision requiring the trustee to reimburse the settlor; and (3) a governing instrument provision which states that the trustee may, in the trustee's discretion, reimburse the settlor. The IRS ruled in situation (2), where the trustee was required to reimbursed the settlor, all of the trust assets would be included in the settlor's gross estate under IRC § 2036(c)(1). Yet, in situation (3), the IRC ruled that the trustee's discretion to reimburse the settlor would not alone cause the inclusion of the trust assets in the settlor's gross estate. But such discretion combined with other facts may cause inclusion of the trust assets. Other facts resulting in inclusion may be: an understanding or pre-existing arrangement between the settlor and the trustee regarding the trustee's exercise of this discretion; a power retained by the settlor to remove the trustee and name the settlor as successor trustee; or applicable local law subjecting the trust assets to the claims of the settlor's creditors. In a typical DAPT the trustee has absolute discretion whether to make distributions to the settlor. Furthermore, a well-planned DAPT will not involve any express or implied agreements or understandings between the settlor and the independent trustee concerning whether such distributions will be made, nor will a settlor have the power to remove the trustee and name the settlor as a successor trustee. Applicable local DAPT state law will prevent a creditor of the settlor from reaching the trust assets. All of the requirements of the revenue ruling should be met by a DAPT and the trust assets should not be included in the settlor's gross estate.

[6] Reservation of powers

In Rev. Rul. 95-58, 1995-2 CB 191, the Service revoked Rev. Rul. 79-353, 1979-2 CB 325, and Rev. Rul. 81-51, 1981-1, CB 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 v. Comm.*, 973 F.2d 1409, 1992-2 USTC ¶60,110 (8th Cir. 1992). This ruling also modified Rev. Rul. 77-182, 1977-1 CB 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 IRC § 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 trustees but adds a requirement that the successor not be related or subordinate to the donor to avoid the adverse estate tax consequences.

In PLR 9809032 the Service ruled that the decedent did not retain interest in an irrevocable trust under IRC § 2036(a)(2), citing *Estate of Wall* and Rev. Rul. 95-58. The trust agreement permitted decedent to determine trustees' compensation, which allowed decedent to encourage trustees to resign by controlling compensation. The decedent did not have the power to appoint a successor trustee, and the power to determine compensation does not affect the beneficial enjoyment of the trust property in such a way that would make the trust includible in decedent's gross estate.

[7] Full and adequate consideration exception

In *Estate of Stone*, TC Memo 2003-309, the Tax Court analyzed whether partnership assets should be included in the taxpayers' estate pursuant to IRC § 2036(a)(1). The Tax Court determined that there had been a transfer of property by the decedents but that the decedents had "received the benefits in full and adequate consideration and in a genuine arms' length transaction." The court specifically rejected the IRS argument that when the value received is less than the value transferred because of the application of appropriate valuation discounts there is not adequate and full consideration.

This is to be contrasted with *Estate of Virginia A. Bigelow v. Comm.*, TC Memo. 2005-65, in which it discussed the bona fide sale for adequate and full consideration exception:

> To constitute a bona fide sale for adequate and full consideration, the transfer of the property must be made in good faith. Estate of Thompson v. Commissioner, supra at 383; sec. 20.2043-1(a), Estate Tax Regs. Such a sale requires that the transfer be made for a legitimate nontax purpose. Estate of Bongard v. Commissioner, 124 TC ____, _____ (2005) (slip op. at 39). Transactions between family members are subject to heightened scrutiny to ensure that the transaction is not a disguised gift. See Harwood v. Commissioner, 82 TC 239, 258 (1984), affd. Without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Stone v. Commissioner, TC Memo. 2003-309; cf. Estate of Reichardt v. Commissioner, supra.

[8] Reciprocal trust doctrine

The reciprocal trust doctrine received its chief statement in *U.S. v. Grace*, 395 US 316 (1969), which incredibly dealt with the estate tax of a decedent who died in 1950. The decedent and his wife created separate trusts 15 days apart, each trust giving the other the right to the income during life and principal in the discretion of the trustee, and a power of appointment to designate by will or deed the manner in which the trust estate at death was to be distributed among the grantor and their children. Over a period of years decedent had transferred property to his wife and that was the property she transferred into the trust she created and the different property of approximately equal value was transferred into the trust the decedent created. The wife predeceased the decedent and the IRS attempted to include her trust in his estate. The Court of Claims held that the trust was not included in his estate, and the Supreme Court accepted certiorari to resolved differences in the circuits, and rejected that the notion that the reciprocal trust doctrine required finding consideration or tax avoidance motives:

> [W]e hold that application of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other. Such a "consideration" requirement necessarily involves a difficult inquiry into the subjective intent of the settlers. Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlers in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.

Estate of Green v. U.S. 68 F.3d 151, 152-153 (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 IRC § 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 *U.S. v. Grace's Estate*, 395 U.S. 316, 324 (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 *Estate of Bischoff*, 69 TC 32 (1977).

PLR 200426008 found that two trusts established by husband and wife differed in substantial respects and decided that the two trusts were not interrelated, even though the trusts contained many identical trust provisions. Neither trust would be included in either grantor's gross estate.

[9] Sale of remainder interest

In *Wheeler v. U.S.*, 77 AFTR2d 97-1141 (W.D., Tex. 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. U.S.*, 897 F.2d 516 (Fed. Cir. 1990) and *Pitman v. U.S.*, 878 F. Supp. 833, (E.D.NC. 1994), the transaction was subjected to IRC § 2036(a)(1) which requires tax on the entire value of the property and not just the value of the remainder interest. The lower court found the transaction to be in substance a gift, not a sale. This case was reversed by the Fifth Circuit, 116 F.3d 749 (1997), in a decision favorable for the taxpayer. Because of Chapter 14, a sale of a remainder interest only works for collateral relatives.

Estate of McLendon v. Comm., 135 F.3d 1017 (5th Cir. 1998), also involved a sale of a remainder interests. This case involved the estate of Gordon R. McLendon, 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 interests. 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. Comm.*, 101 F.3d 309 (3rd Cir. 1996), the Third Circuit reversed the Tax Court, 105 TC 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. The Ninth Circuit has joined the Fifth and Third Circuits with regard to sales of a remainder interest. *Estate of Magnin v. Comm.*, 184 F.3d 1074 (9th Cir. 1999) on remand 2001 WL 117645, 81 TCM (CCH) 1126. On remand, the Tax Court determined if the exchanged interests were of "approximately equal value," and concluded that an approximate 2-to-1disparity between the remainder interest transferred by the decedent and the consideration received by the decedent does not support a finding that the two interests were of "approximately equal value." Because decedent did not receive approximately equal value and therefore did not receive full and adequate consideration and required inclusion of the entire interest in the decedent's estate under IRC § 2036(a). *Magnin v. Comm.*, 2001 WL 117645, 81 TCM (CCH) 1126.

[10] Sales and leasebacks

In *Estate of Maxwell v. Comm.*, 3 F.3d 591, 593-594 (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 § 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 arm's length and the transactions do not contain an element of gift.

[11] Retained voting rights

The Instructions, p. 14, set forth the so called "anti-Byrum rule" of IRC § 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 in the gross estate as if the decedent had actually retained the voting rights until death.

Retention of voting rights will require appraisal of the business interest to which the rights relate. For example, if decedent held voting rights on 40% of the stock, then a 40% interest in the business will need to be valued.

[12] Income tax defective grantor trusts

An income tax defective grantor trust is designed to cause the grantor to be liable for the income taxes generated by the trust income but to

retain insufficient rights to cause inclusion in the grantor's estate for federal estate tax purposes.

Rev. Rul. 2004-64, 2004-27 IRB 7, blessed the gift tax aspects of defective grantor trusts while addressing the estate tax aspects under varying trust provisions. The ruling held that when the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries. If the governing instrument of the trust requires the trustee to reimburse the grantor from the trust's assets for the amount of income tax the grantor pays that is attributable to the trust's income, the grantor has retained the right to receive reimbursement attributable to the trust's income and causes the full value of the trusts assets at the grantor's death to be included in a gross estate under IRC § 2036(a)(1). The same result occurs where applicable state law requires the trustee to reimburse the grantor in the absence of a governing instrument provision that provides otherwise. Yet, the Service will not apply this ruling adversely to a grantor's estate with respect to any trust created before October 4, 2004. If the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion whether or not exercised will not cause the value of the trust's assets to be includible in the grantor's gross estate.

In LTR 200120021, issued prior to Rev. Rul. 2004-64, the grantor created a trust in which either the trustee or the trust protector, who was not related or subordinate as defined in IRC § 672, had the discretionary power to satisfy the grantor's income tax liability attributable to the income of the trust. The grantor retains the lifetime power to acquire the assets of the trust by substituting property of equivalent value. The IRS ruled that the discretionary power to pay the grantor's tax liability will not constitute retention of the grantor of the right to the income or enjoyment of the property under IRC § 2036(a).

[13] Payment of taxes

PLR 199922062 ruled that a trust's requirement that the trustee use trust funds to pay federal income tax liability incurred by the grantor as a result of the trust will not cause the trust to be included in the grantor's estate. Here, the distributions on the grantor's behalf represent tax payments allocable to the trust, and the IRS ruled they are not a retention of the right to income. IRC § 2036(a). If the trustee were required to reimburse the grantor for any tax liability not attributable to the trust, then the grantor would have retained an income interest under IRC § 2036(a).

[14] Decedent's private foundation

Include on Schedule G under IRC § 2036 the value of decedent's private foundation on which decedent served as director and trustee. In Rev. Rul. 72-552, 1972-2 CB 525, the decedent transferred during life property to a non-profit corporation of which he was president and a director. Due to decedent's right, exercisable in conjunction with others, to designate the charitable entities that would possess or enjoy the property transferred to the corporation the property transferred by the decedent to the corporation was included in the decedent's gross estate under IRC § 2036. The ruling would appear also to be applicable to a charitable trust of which decedent was donor and trustee. Schedule O will have a deduction equal to the property reported on Schedule G, creating a wash for purposes of determining the net estate, but inclusion in the gross estate of the private foundation property may change calculation of gifts dependent upon formulas, such as "one-half of my adjusted gross estate," may also effect the calculation of executors' and trustees' commissions, and will count towards the threshold amount for filing a return.

[15] Right to control income

Some practitioners are concerned about the language in IRC § 2036(a)(2), which requires inclusion in the estate where the decedent held "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

Even with regard to an irrevocable trust where the decedent in the trust instrument had given up all rights to amend or revoke the instrument under the common law or virtually all trust codes the grantor has the power with all beneficiaries to amend the terms of the trust agreement. This provision as to income can be read as parallel to the provisions of IRC § 2038 as to principal. According to Treas.Reg. §20.2038-1(a)(2), Section 2038 does not apply.

> If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in a transferred property, and if the power adds nothing to the rights of the parties under local law.

The argument would appear to be that the lack of a specific regulatory language does not diminish the intent that the statutory provision not be applicable to the power of the decedent as grantor along with the beneficiaries to amend the trust in the IRC § 2036 context as well as IRC § 2038.

[16] Life estate upon disclaimer of remainder interest

T. Walshire, Executor, 2002-1 U.S.TC ¶60,439 (8th Cir. 2002), affirmed the District Court's decision upholding Treas.Reg. §25.2518-3(b) as a valid construction of IRC § 2518 when the regulation requires a disclaimer of an undivided interest in property and prohibits a disclaimer of a remainder interest while retaining a life estate. The decedent attempted to disclaim a remainder interest in his one-fourth share of his deceased brother's residuary estate while reserving the income and use of the property during the decedent's life. The executors of the decedent's estate did not include the value of the disclaimed property on his estate tax return. Upon audit, the IRS determined that the disclaimer was not a qualified disclaimer and the property was properly includable in the decedent's estate.

[17] Retained interests not included

The power of the grantor and beneficiaries to revoke an irrevocable trust under common law will not be viewed as a retention requiring inclusion. See the discussion of §11.02[E][5] dealing with revocable transfers that are not included.

[18] GRATS and GRUTS

See discussion of "Grantor retained annuity trusts (GRAT) and Grantor Retained Unitrusts (GRUT)" below.

[D] Transfers taking effect at death, IRC § 2037

[1] Reversionary interests included

The gross estate includes the value of property that the decedent transferred if possession or enjoyment of the property requires surviving the decedent and the decedent retained a *reversionary interest* (discussed below) 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.

[2] Reversionary interest defined

The Instructions, p. 11, state:

> A ***reversionary interest*** is generally any right under which the transferred property will or may be returned to the decedent or the decedent's estate. It also includes the possibility that the transferred property may become subject to a power of disposition by the decedent. It does not matter if the right arises by the express terms of the instrument of transfer or by operation of law. For this purpose, reversionary interest **does not** include the possibility the income alone from the property may return to the decedent or become subject to the decedent's power of disposition.

An example would be a completed gift by the decedent to his 80 year old mother with a provision that upon her death it passed back to the decedent or his estate. If the decedent dies before his mother, the reversionary interest is greater than 5%. The remainder interests in a trust created by the decedent should be examined to determine if there are interests that can revert back to the decedent or the decedent's estate.

In the event where multiple parties must predecease the decedent for the property to revert, it may be necessary to request a private letter ruling from the IRS National Office for its calculation of the reversionary interest.

[E] Revocable transfers, IRC § 2038

[1] According to instructions

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 includable 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 includable 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 includable in the gross estate, see the Estate Tax Regulations.
>
> Instructions, p. 14.

[2] Possible revocable transfers

In *Kisling v. Comm.*, 32 F.3d 1222, 1225-1226 (8th 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 IRC §s 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.

[a] Gifts under power of attorney

In TAM 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 v. Comm*, 71 TCM (CCH) 1896 (1996), 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 includable in the decedent's gross estate. The decedent was terminally ill with cancer, and in November and 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 17th. 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.

Gifts of decedent's property by decedent's attorney-in-fact prior to decedent's death were included in decedent's gross estate. The attorney-in-fact was not authorized under Connecticut state law to make gifts as an agent of the decedent. The general power of attorney did not include an express authorization to make gifts, and decedent had not established a pattern of gift giving prior to his death. *Gaynor Est.* TC Dec. 54,440 (M) (2001).

The value of 38 inter vivos gifts of $10,000 each, made by a decedent's attorney-in-fact, was includable in the decedent's gross estate because the gifts were void under California law and thus the decedent retained a power of revocation over the gifts. The principal allegedly ratified the gifts by nodding her head at the names of the donees, but this informal validation was insufficient to validate the gifts. *Swanson v. U.S.*,46 Ct.Fed.Cl. 388 (2000).

[b] Texas powers

TAM 940304 held that Texas law does not authorize attorneys-in-fact to make gifts unless specifically authorized in the power of attorney. Either get a new power of attorney signed or follow the gift procedure for incompetents in Tex. Prob. Code § 865.

In *Estate of M. Hubberd v. Comm.*, 76 TCM (CCH) 963 (1998), 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 includable 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 § 2038, the interest was includable 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.

The IRS position and the Tax Court's holding regarding Texas law are supported by a reading of the Texas Durable Power of Attorney Act, Tex. Prob. Code §481 *et seq.*

> Special instruction applicable to gifts (initial in front of the following sentence to have it apply):
>
> I grant my agent (attorney in fact) the power to apply my property to make gifts, except that the amount of a gift to an individual may not exceed the amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift.

By requiring the affirmative act of initialing the sentence, even a general power of attorney does not include the authority to make gifts unless the

principal makes an affirmative act to grant the power.

[c] Uncashed gift checks

Checks drawn on decedent's checking account by her attorney-in-fact prior to the decedent's death but neither accepted nor paid by the drawee bank until after her death were includable in the decedent's gross estate because the decedent possessed until her death the power to revoke the checks. *Estate of S. Newman v. Comm.*, 111 TC 81(1998).

Checks written by a decedent to friends and relatives, in amounts less than permitted annual exclusion gifts but not paid until after the decedent's death, were held to be incomplete gifts because the decedent could have stopped payment on the checks any time during her life until the checks were paid and, therefore, were included in the decedent's gross estate. *Rosano v. U.S.*, 245 F.3d 212, 213-214 (2nd Cir. 2001). The "relation-back" doctrine applicable to transfers to charitable organizations did not apply to gift checks to friends and relatives.

[d] Court authorized gifts

In *Estate of Lucille Devlin v. Comm.*, 78 TCM (CCH) 948 (1999), when decedent became incompetent, her guardian-conservator received authorization to make gifts to her children and grandchildren. In April of the year of her death, authorization was received for gifts that year, but they were completed two weeks after her death in October. The tax court held that even though the gifts were court authorized they were not completed gifts and must be included in the gross estate. The moral is to not rely on an order of authorization, but to make the gifts.

[e] "Unauthorized" gifts

In *Estate of Halpern v. Comm.*, 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 includable in decedent's gross estate. Post-incompetency distributions were includable 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 *Estate of Floy Christensen v. Comm.*, TC Memo. 2000-368, the Tax Court held that checks written to decedent's relatives during her life from a joint bank account that her two adult children held with her were revocable and includable in decedent's estate.

[3] Custodial gifts

Transfers to minors where the decedent is both the donor and the custodian will be includable in the decedent's gross estate if the decedent dies before the donee reaches majority. Rev. Rul. 57-366, 1957-2 CB 618; Rev. Rul. 59-357, 1959-2 CB 212, amplified by Rev. Rul. 70-348, 1970-2 CB 193. Includability is required where the decedent is successor custodian regardless of whether the decedent named himself or herself as initial custodian or subsequently is appointed custodian. Rev. Rul. 70-348, 1970-2 CB 193. The ability as custodian to pay the income or principal to the minor or to withhold enjoyment of the property from the minor until the minor reaches majority, the value of the custodial property is includable in custodian's gross estate under IRC § 2038(a)(1) as a transfer in respect of which the donor custodian retained a power to alter, amend, revoke, or terminate. Uniform Transfers to Minors Act, §14, entitled "Use of Custodial Property," states in part,

> (a) A custodian may deliver or pay to the minor or expend for the minor's benefit so much of the custodial property as the custodian considers advisable for the use and benefit of the minor . . .

The Comment to this section as well as the comments to other sections discuss Federal tax aspects of the Uniform Act, but does not discuss inclusion in the donor-custodian's estate under IRC § 2038.

In the situation where the property is held by the donor-custodian on the date of death for a person who has now reached majority, the property should not be included in the custodian's gross estate. See PLR 9032002 and TAM 9109033. Rev. Rul. 57-366, 1957-2 CB 618, requires inclusion in the estate of the custodian "in the event of his death while acting as custodian and before the donee attains the age of 21 years," clearly implying that there is no inclusion when the donee has reached majority before the date of death.

[4] Non-disclosure

Just as annual exclusion gifts made by the decedent are not required to be reported on the estate tax return, annual exclusion gifts made under a power of attorney are also not disclosed because it is believed that they are not revocable. The IRS usually tries to find these on audit. But the following

anachronistic regulation would appear to give them additional authority to request that they be reported:

> All transfers made by the decedent within 3 years before the date of his death of a value of $1,000 or more and all transfers (other than outright transfers not in trust) made by the decedent at any time during his life of a value of $5,000 or more, except bona fide sales for an adequate and full consideration in money or money's worth, must be disclosed in the return, whether or not the executor regards the transfers as subject to the tax. If the executor believes that such a transfer is not subject to the tax, a brief statement of the pertinent facts shall be made.

Treas. Reg. §20.6018-3(c)(7).

The regulation does not reflect the changes made to IRC § 2035 by ERTA in 1981. The Instructions, p. 14, revise this reporting requirement:

> 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 the Schedule regardless of whether you believe the transfers are subject to tax.

[5] 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:

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

(2) 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.

(3) 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.

[6] "Revocable" transfers not included

The grantor and the beneficiaries can agree to terminate an irrevocable trust, yet this power should not be seen as making the trust revocable and includable in the grantor decedent's gross estate under IRC § 2038. The regulations say that Section 2038 does not apply "If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law." Treas. Reg. §20.2038-1(a)(2). An explicit provision in the trust instrument does not invoke Section 2038 if the provision is cumulative of state law. In *Helvering v. Helmholz*, 296 U.S. 93 (1936), the Supreme Court decided as to the predecessor to IRC § 2038, that it did not apply to an instance where the grantor and beneficiaries held under the provisions of the trust itself the power to revoke or modify the trust. The Supreme Court held that this did not amount to a joint power to revoke.

> This argument overlooks the essential difference between a power to revoke and a condition which the law imposes. The general [common law] rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax at death of the settler a trust created in a state whole law permits all of the beneficiaries to terminate the trust.

§10.03 *Grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs)*

The issue often arises whether or not a GRAT or a GRUT is includable in the estate of the grantor. Generally, if the grantor survives the term, then the GRAT or GRUT is not included in the grantor's estate. For example, grantor establishes a GRAT paying himself $5,000 per year for 10 years and grantor dies in year 12. No part of the GRAT will be included in grantor's estate. However, if grantor dies prior to the expiration of the term of the GRAT or GRUT (e.g., in year 5), then part or all of the GRAT or GRUT will be included in grantor's estate.

[A] GRAT defined

"A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A fixed amount means a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically, but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage in the preceding year."

Treas. Reg. § 25.2702-3(b)(1).

[B] GRUT defined

"A qualified unitrust interest is an irrevocable right to receive payment periodically, but not less frequently than annually, of a fixed percentage of the net fair market value of the trust assets, determined annually. The unitrust amount must be payable to (or for the benefit of) the holder of the unitrust interest

at least annually. A fixed percentage is a fraction or percentage of the net fair market value of the trust assets determined annually, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year." Treas. Reg. § 25.2702-3(c)(1).

[C] Inclusion if grantor dies prior to expiration of fixed term of GRAT or GRUT

If grantor dies prior to the expiration of the fixed term, then the GRAT or GRUT will usually be included in the grantor's estate based on IRC §s 2036(a)(1) or 2039. The IRS tends to favor inclusion under IRC § 2039, since that section often results in a larger inclusion of the GRAT or GRUT in the grantor's estate. However, IRC §s 2033 and 2038 can also cause inclusion of a GRAT or GRUT in the grantor's estate.

[1] Revenue rulings

"Revenue Rulings 76-273, 1976-2 CB 268, and 82-105, 1982-1 CB 133, relate to the amount of a charitable remainder unitrust and a charitable remainder annuity trust that is includable in the grantor's gross estate under IRC Sec. 2036(a)(1). Their holdings should also apply to the amount of a GRAT or GRUT that is includable in the grantor's gross estate when he dies during the fixed term of his retained interest." *IRC Sec. 2702–GRITs, GRATs and GRUTs and Other Related Transactions*, U.S. Trust–Practical Drafting, April 1999, at 5597. For an example of how to calculate an unitrust under Rev. Rul. 76-273 and an annuity trust under Rev. Rul. 82-105, see the section "Charitable remainder trusts", below. See also TAM 200210009. IRC § 2036 includes not merely the present value of the remaining annuity payments, but the amount of property necessary to produce a sufficient amount of income using the prevailing IRC § 7520 rates, to fund the remaining annuity payments. Hence, the amount included under IRC § 2036 equals the annuity amount divided by the IRC § 7520 rate on the valuation date.

[2] IRC § 2039

The gross estate of a decedent shall include the value of an annuity or other payment received by any beneficiary by reason of surviving the decedent under any form of contract or agreement if, under the contract or agreement, an annuity or other payment was payable to the decedent. IRC § 2039(a).

The IRS in PLRs 9451056 and 9345035 held that if a GRAT or a GRUT provides that the grantor's interest terminates upon the earlier of the fixed term or the death of the grantor, then the survivorship requirement of IRC Sec. 2039(a) would be met, if the trust property passes to the remainderman at that time and not to the grantor's estate. *See also*, FSA 200036012. However, if the payments from the GRAT or GRUT continued to the grantor's estate for the balance of the fixed term, it appears that the survivorship requirement under IRC § 2039(a) would not be satisfied, and therefore the GRAT or GRUT would not be includable in the decedent's gross estate because the remaindermen would not receive the trust property by reason of surviving the grantor. *IRC Sec. 2702–GRITs, GRATs and GRUTs and Other Related Transactions,* U.S. Trust–Practical Drafting, April 1999, at 5599. (Note: The GRAT or GRUT may still be partially or wholly includable in the decedent's estate under IRC § 2036(a)(1).). Also, if the grantor dies after the fixed term, then the GRAT or GRUT will not be included in the decedent's gross estate.

> The amount to be included in a decedent's gross estate under section 2039(a) and (b) is an amount which bears the same ratio to the value at the decedent's death of the annuity or other payment receivable by the beneficiary as the contribution made by the decedent, or made by his employer (or former employer) for any reason connected with his employment, to the cost of the contract or agreement bears to its total cost.

Treas. Reg. § 20.2039-1(c).

An example of this rule is illustrated in Treas. Reg. § 20.2039-1(b)(2), Example 1:

> The decedent purchased an annuity contract under the terms of which the issuing company agreed to pay an annuity to the decedent for his life and, upon his death, to pay a specified lump sum to his designated beneficiary. The decedent was drawing his annuity at the time of his death. The amount of the lump sum payment to the beneficiary is includable in the decedent's gross estate under section 2039(a) and (b).

Despite Covey's observation set forth above, the Service takes the position that all of the property in a GRAT is includable in the grantor's estate under IRC § 2039. In TAM 20021009, the IRS ruled that under IRC § 2039(a), the entire value of the GRAT corpus was included in the grantor's estate. Under the GRAT, the trustees were to pay the grantor for 10 years an annuity equal to 15 percent of the FMV of the initial trust corpus. When the grantor died during the sixth year of the term, pursuant to the trust terms, the annuity was to be paid to the grantor's estate for the balance of the term, and then the trust went to the grantor's descendants. The IRS concluded that all

post-death payments from the GRAT were receivable by reason of surviving the decedent under IRC § 2039(a). See also FSA 200036012 and PLR 91451056. The Service's position applies for both a fixed-term GRAT and a GRAT with a grantor retained reversion.

[3] IRC § 2033

"The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." IRC § 2033. If a grantor's estate is entitled to receive the balance of the payments of a fixed term of a GRAT or GRUT, then the grantor's gross estate should include the actuarial value the remaining payments.

[4] IRC § 2038

Under IRC § 2038 the actuarial value of the GRAT or GRUT payments would be includable in the grantor's gross estate, if the grantor retains a power of appointment over the balance of the GRAT or GRUT payments and if the grantor dies prior to the expiration of the retained term.

§10.04 *Charitable remainder trusts*

Most preparers assume that with a charitable remainder trust in which the grantor retained the non-charitable interest prior to the charitable remainder that the entire value of the trust is included in the decedent's gross estate under IRC § 2036. Inclusion is not an issue because the remainder interest passing to a charitable organization will be deducted on Schedule O. But, this expected valuation wash may not materialize in those instances in which there are other non-charitable beneficiaries other than the grantor-decedent or the grantor-decedent's spouse.

[A] Charitable remainder unitrust inclusion

Rev. Rul. 76-273, 1976-2 CB 268, provided that the entire value of the corpus of an intervivos charitable remainder unitrust from which the grantor retained a life payment of a unitrust adjusted payout rate that was equal to or greater than the unitrust adjusted payout of the then applicable federal rate of 6% would be included in the decedent's estate. Because the payout rate from the untirust was equivalent to a full income interest in the trust assets, the grantor effectively retained the income from all the assets transferred to the unitrust and thus the entire value of the property in such trust is includible in the grantor's gross estate. The ruling was issued when the applicable federal rate was set at 6%, but the reasoning of the ruling applies when comparing the unitrust rate to the applicable federal rate set under IRC § 7520. Where the grantor retains the right to a unitrust amount having an adjusted payout rate of less than the adjusted payout rate of the applicable federal rate, then a reduced proportion of the trust assets will be includible in the gross estate. The equivalent rate for the unitrust is divided by the applicable federal rate, and that proportion of the value of the trust property is included in the decedent's estate. The adjusted applicable rate comes from this formula:

Equivalent income interest rate =

$$\frac{\text{Unitrust adjusted payout rate}}{\text{One minus adjusted payout rate}}$$

The applicable federal rates are determined as of the date of the decedent's death. Less than full inclusion will occur when the unitrust rate at the grantor's death is less than the then applicable IRC § 7520 rate after being modified to an adjusted payout rate.

[B] Charitable remainder annuity trust inclusion

Rev. Rul. 82-105, 1982-1 CB 133, held that for purposes of IRC § 2036 the portion of the value of a charitable remainder annuity trust that is includible in the grantor's gross estate at death is the amount necessary at the then applicable federal rate of 6% to yield the annuity payment. The six percent rate has now been replaced by the IRC § 7520 rates. Example: if on the date of death the applicable 7520 rate was 8%, the annuity was $2,000 a month or $24,000 a year, and the value of the trust assets in the trust was $400,000, then three quarters of the trust will be included in the decedent's estate and reported on Schedule G.

$$\frac{\$24{,}000}{8\%} = \$300{,}000 \qquad \frac{\$300{,}000}{\$400{,}000} = 3/4$$

§10.05 *Unsuccessful estate freezes*

Most unsuccessful estate freezes, those properly established according to the rules of Chapter 14 but the grantor dies before the term of the freeze expires, will be reported on Schedule G.

[A] Common law GRIT

The old common law GRIT continues to be available under Chapter 14 when the remaindermen are not members of the grantor's family. The grantor will retain the right to receive the income for a fixed term or until his earlier death. If the grantor dies during the fixed term, then the trust property will be included in the gross estate of the grantor under IRC § 2036(a)(1), because the grantor has retained the

interest for a "period which does not in fact end before his death." The unified credit used when the GRIT was created is restored and any gift tax paid is a credit against the estate tax liability.

[B] Qualified personal residence trust

These trusts are provided for in Treas. Reg. §25.2702-5(b)(3). The grantor places a personal residence in trust and retains the right to use the residence for a term of years. If the grantor does not survive the fixed term, then the entire value of the property in the trust, primarily the residence also possibly some cash, will be included in the decedent's estate under IRC § 2036(a)(1). The unified credit used when the QPRT was created is restored and any gift tax paid is a credit against the estate tax liability.

§10.06 *Section 529 plans*

It is difficult to know where to discuss on what schedule an item should be *excluded*, but Schedule G appears to be the appropriate schedule to list a portion of Section 529 plans. Qualified prepaid tuition and college savings plans under IRC § 529 are in some respects an estate tax oddity, because they can be of substantial value, revocable, but not included in the owner's estate.

[A] Plan exclusions

The account balance will not be included in the gross estate of the account owner, regardless of any control the account owner may have over the account, any issue of support, or the possibility of refund or reversion (revocable). IRC § 529(c)(4)(A). Upon death, the account is an asset of the account owner's probate estate, and the successor to the account owner can change the beneficiary or liquidate the amount, yet nothing is included in the federal gross estate of the deceased owner.

[B] Partial plan inclusions

Under IRC § 529(c)(2)(B), a plan donor may elect to take certain contributions to a plan into account ratably over a five-year period in determining the amount of annual exclusion gifts made during the calendar year. If the donor dies during the five-year term, the account owner's estate will include any amounts allocated to periods after the death of the account owner. IRC § 519(c)(4)(C).

[C] Possible unreported gifts

The provision for amortization cannot exceed five times the annual exclusion available in the year of the contribution. Any excess may not be amortized and should have been treated as a taxable gift in the calendar year of the contribution. If not reported by the account owner during life, the executor must report the gift.

§10.07 *How reported*

[A] 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 otherwise described in the Instructions are to be reported on a statement attached to Schedule G. Instructions p. 14.

[B] Required information

For each transfer, list the transferee, the date of the transfer, and give a complete description of the property. Instructions, p. 14.

[C] 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. 14.

[D] 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.

[E] 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.

§10.08 *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. Instructions, p. 14. Copies are also required if the transfer must be disclosed but the value is not included in the gross estate. Treas. Reg. §20.6018-4(f). A certified copy is a copy from the county clerk's office with the clerk's certificate that it is a true and accurate copy. A verified copy is a copy signed by a trustee stating under penalties of

perjury that the document is a true and accurate copy. Document 4, Sworn Verification, gives a sample form of verification.

Before being the notary on such a verification, a preparer should consider the IRC guidance on preparers as notaries, Treas. Circular 230, §10.27 Notaries.

> No attorney, certified public accountant, enrolled agent, or enrolled actuary as notary public shall with respect to any matter administered by the Internal Revenue Service, take acknowledgments, administer oaths, certify papers, or perform any official act in connection with matters in which he is employed as counsel, attorney, or agent, or in which he may be in any way interested before the Internal Revenue Service.

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. Instructions, p. 13.

4. An explanation of how includable gift taxes were computed if not all gift taxes are included for gifts shown on Form 709 for gifts within three years of death. Instructions, p. 13.

5. If the answer to Question 12a is "yes" a copy of the trust instrument for each trust must be attached. Instructions, p. 11.

Document 5 - Sworn Verification

ESTATE OF JOHN Q. SAMPLE
Form 706 Schedule G, Item 8

Attached is a true and accurate copy of THE SAMPLE CHILDREN'S TRUST OF 1983.

_____
Richard V. Sample

The State of Texas §
County of Bexar §

This instrument was acknowledged before me on _____, 2001, by Richard V. Sample, Trustee of THE SAMPLE CHILDREN'S TRUST OF 1983.

_____
NOTARY PUBLIC, in and for the State of Texas

§10.09 *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).

11 SCHEDULE H - POWERS OF APPOINTMENT

§11.01 *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 can be read to expand on this and require a listing on Schedule H of any power of appointment, general or non-general. Listing general and non-general powers according to this reading gives the IRS the opportunity to determine if what the executor and preparer believe to be non-general is in their view general.

§11.02 *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 for which the decedent possessed a general power of appointment that 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 includable 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. 15.

§11.03 *Exceptions*

[1] "[P]roperty subject to a power of appointment is not includable in the gross estate if the decedent released the power completely and the decedent held no interest in or control over the property." Id. Property covered by the release may be a taxable gift at the time of the release. Although the released property is not included in the decedent's gross estate, the preparer may need to report an inter vivos gift.

[2] "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*.

§11.04 *General power of appointment*

[A] Defined

The Instructions, p. 15, 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.
>
> Instructions, p. 15.

According to the Instructions, p. 15, 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 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.

What if the grantor gives her daughter a testamentary power of appointment in favor of the grantor's descendants? The daughter holding the power is obviously a descendant, but in PLR 200210038, the IRS ruled that the power was not a general power of appointment and the trust was not included in the deceased daughter's estate. Because the power was a testamentary power, the daughter could not appoint the trust to herself or her creditors during her life. The reference to "[Grantor's] descendants" is properly viewed as not including daughter's estate or daughter's creditors after daughter's death, the ruling concluded.

Connecticut Bank & Trust Company v. US, 465 F.2d 760 (2nd Cir. 1972), addressed whether wrongful death proceeds, which under Connecticut law passed according to the decedent's will, were subject to a general power of appointment and includible in the decedent's estate because they are to be distributed under the terms of the decedents' wills. The court said that this effectively "asserts that any property which is distributed according to a testamentary disposition is taxable as part of the gross estate, a view which enlarges the statute far beyond the purposes intended for it by Congress.. . . [P]roperty subject to a § 2041 power of appointment must be in existence prior to the time of the decedent's death." *Id*. at 764. In Rev. Rul. 75-127, 1975-1 CB 297, the IRS agreed to follow the reasoning of this case, that the wrongful death proceeds are not includible in the decedent's gross estate under IRC § 2041 because the wrongful death action cannot exist until the decedent has died, and thus the decedent did not possess a power of appoint over such cause of action at the time of his death.

[B] Partial powers

The Instructions provide this definition and guidance regarding partial powers:

> A part of a power is considered a general power of appointment if the power:
>
> 1. May only be exercised by the decedent in conjunction with another person; and
>
> 2. 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. 15.

[C] Grandfathered general powers

The preparer will only rarely come across these, for obvious reasons, but certain powers of appointment created before October 22, 1942, that are exercisable by the decedent only in conjunction with another person, are not a general power of appointment. Further, property subject to a general power of appointment created before October 22, 1942, is not included in the decedent's estate simply because decedent *possessed* the power; inclusion in decedent's estate is required only when decedent *exercises* the power. PLR 200205033 ruled that two general powers of appointment created before October 22, 1942, by the decedent's mother were not

exercised by decedent and not included in her gross estate. *See also* 200225015.

If a general power of appointment created before October 22, 1942, is partially released before November 1, 1951, so that it is no longer a general power of appointment, its exercise does not require inclusion in the decedent's estate. IRC § 2041.

Estate of *Greve v. Comm.*, TC Memo 2004-91, is a case of a rare pre-October 22, 1942, general power of appointment held by the decedent that was inadvertently exercised, under Pennsylvania law, by the residuary clause in decedent's Will.

[D] Date powers are created

The Instructions give these rules as to when a power is created.

> Generally, a power of appointment created by will is considered created on the date of the testator's death.
>
> A power of appointment created by an inter vivos instrument is considered created on the date the instrument takes effect. If the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first.

Instructions, p. 15.

[E] Examples

[1] 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 under IRC § 2056 (b)(5).

The IRS followed the rule of consistency in TAM 200407018 in requiring inclusion in the decedent's estate where a marital deduction under IRC § 2056(b)(5) was taken on the predeceased spouse's estate tax return. The spouse's will gave the decedent a life estate with a remainder to the children in oil paintings. A particular painting was thought to be pastel and was treated as passing under a will provision in which the decedent received a qualifying life estate with a general power of appointment, and a marital deduction under IRC § 2056(b)(5) was taken. When decedent died and the painting sold, it was determined that it was in fact an oil painting. Decedent's personal representatives claim that the decedent did not have a general power of appointment and the marital deduction on the spouse's return was improper. The duty of consistency as a doctrine prevents a taxpayer from taking one position on a tax return and taking a contrary position on a subsequent tax return if the statute of limitations had run on the prior return and if the contrary position is to the detriment of the IRS. The elements of the doctrine are: (i) a representation by the taxpayer; (ii) reliance on it by the IRS; and (iii) an attempt to change positions after the statute of limitation had expired. The IRS found all of these elements present in this case: (i) the spouse's estate tax return presented that decedent had a general power of appointment and a marital deduction was taken; (ii) the IRS relied on this representation by not taxing the painting in the spouse's estate; and (iii) decedent's estate claims that the decedent did not have a general power of appointment, the painting should not have qualified for a marital deduction in the spouse's estate, yet the statute of limitations on spouse's estate had expired. Although the spouse's estate and the decedent's estate are different taxpayers, the IRS found sufficient privity between them to bind decedent's estate to representations made by the spouse's estate.

[2] 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.

[3] Joint revocable trusts

Practitioners in common law states have tried to develop a trust giving husband and wife such powers that regardless of which spouse died first, the entire property, including that of the surviving spouse, will receive a step-up in basis upon death of the first spouse to die, much like the step-up in basis given to both halves of community property upon the death of a spouse. The IRS has blessed this effort to a limited extent with a specially designed general power of appointment joint revocable trust. PLR 200101021. Husband and wife created a revocable trust and funded it with assets owned as tenants by the entireties. The first spouse to die possessed a testamentary general power of appointment over the entire trust. Upon failure to exercise the power of appointment, the trustee was to fund a credit shelter trust with the unified credit amount for the benefit of the survivor, and any excess passed outright to the survivor.

Favorable to the taxpayer and to the concept of such trusts to replicate step-up in basis of both halves of community property, the IRS ruled that on the death of the first spouse, the entire trust will be included in the first spouse's estate under IRC § 2038 (revocable transfers) and IRC § 2041 (general power of appointment) and the surviving spouse will be treated as making a completed gift of his or her one-half interest in the trust under IRC § 2501 that is eligible for the gift tax marital deduction under IRC § 2523.

The IRS also ruled: (1) the initial funding of the trust will not be a gift for gift tax purposes because each spouse retains the power to terminate at will; (2) trust distributions to either spouse during their joint lives will be a gift by the other spouse to the extent of 50 percent of the value of the assets distributed and will qualify for the gift tax marital deduction; (3) if the credit shelter trust is funded, property passing to the trust will be treated as passing from the deceased spouse and not the surviving spouse and payments from that trust to beneficiaries other than the surviving spouse will also not be gifts from the surviving spouse; (4) none of the assets in the credit shelter trust will be included in the surviving spouse's federal gross estate, since the surviving grantor will possess only a special power of appointment with respect to those assets; and (5) IRC § 1014(e) will apply to any trust property includable in the deceased grantor's gross estate that is attributable to the surviving spouse's contribution to the trust and is acquired by the surviving grantor either directly or indirectly pursuant to the deceased spouse's exercise or failure to exercise the general power of appointment and it receives the step-up in basis. What the ruling did not state was that IRC § 1014(e) should not apply to property passing to the credit shelter trust and it receives the step-up in basis. Your author does not see in the ruling any significance that the property was tenancies by the entireties as opposed to co-tenancy or individually owned property, but the ruling only applies to tenancies by the entireties because that is the only type of property covered by the ruling request and the ruling. In reporting such trust on an estate tax return, report on Schedule G as much as possible amounts under IRC § 2038 because they are not subject to IRC § 1014(e), on Schedule H report but do not overstate the amount subject to IRC § 2041 because these amounts are subject to IRC § 1014(e), and to the extent possible have the property reported on Schedule M be that reported on Schedule G rather than that reported on Schedule H.

It has been stated that a taxpayer need not request his or her own private letter ruling, because this ruling is obviously correct. Jeffrey Pennell, Comment, Philip E. Heckerling Institute on Estate Planning, Jan. 2002. In preparing the estate tax return, your author would not request a private letter ruling, but if prior to the death of the first spouse to die, would recommend to the taxpayers that a private letter ruling request be made, because PLR 200101021 only dealt with tenancies by the entireties and a ruling addressing the particular property at issue should be requested, and the concept of the surviving spouse's transfer to the deceased spouse as qualifying for the gift tax marital deduction seems questionable. A similar ruling was given in PLR 200210051.

In PLR 200403084 the Service approved a revocable trust settled by husband that gave the wife, in the event she predeceased husband, a testamentary general power of appointment to appoint part of the assets of the trust estate having a value equal to (i) the amount of the wife's remaining applicable exclusion amount less (ii) the value of her taxable estate determined by excluding the assets subject to the power. The trust arrangement enabled the wealthier spouse to retain control over assets during his life yet assured that the wife's unified credit will be fully utilized in the event she predeceased the husband.

[4] 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 § 2041(b)(2).

In *Estate of Kurz by First Nat. Bank of Chicago v. Comm.*, 68 F.3d 1027 (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 $170,000, in wife's estate under IRC § 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. IRC § 2041 is designed to include in the taxable estate all assets that the decedent possessed or effectively controlled.

In *Estate of Myrtle V. Dietz v. Comm.*, 72 TCM (CCH) 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 § 2041(b)(2).

If the decedent was agent under a power of attorney given by a principal other than the decedent, and the power of attorney gave the decedent power to make gifts to potential donees that included the decedent, does the decedent hold a power of appointment that requires inclusion of the principal's property in the decedent's gross estate? Your author has not located a case that answers the question, but it seems that if the amount that the decedent can give himself or herself, usually the annual exclusion amount of $10,000, exceeds the greater of $5,000 or 5%, then inclusion would be required. This would be the case if the principal's property subject to gift was less than $200,000. If the property was $200,000 or more, 5% would be $10,000 or more and the gift power comes within the general power of appointment exception, but if the gift had not been made for the year of death then the amount that could be appointed to the decedent would need to be included in the decedent's gross estate.

[5] 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 § 2041 general power of appointment, and should be listed on Schedule H.

[6] Crummey withdrawal rights

If the decedent held exercisable Crummey withdrawal rights or hanging powers created by another, those rights must be included on Schedule H.

[7] Reformation out of general power of appointment

PLR 200201017 is a ruling where a reformation petition was filed to correct a scrivener's error, consistent with applicable California law, reforming a son's general power of appointment on a GST exempt trust to a limited non-general power of appointment. If the court agreed with the petition, the IRS ruled that the son never held a general power of appointment that would be included under IRC § 2041(a)(2) in son's gross estate and there was no lapse of a general power of appointment that would be considered a release under IRC § 2514(3). This ruling was sought while the son was alive and the ruling may have been different had the reformation petition been filed after son's death. A related ruling is at PLR 200201020.

[F] Delaware tax trap

IRC § 2041(a)(3), commonly known as the "Delaware tax trap," provides that a special power of appointment can be exercised in such a manner as to become a general power of appointment. If the decedent exercises a special power of appointment created after October 21, 1942, by creating another power of appointment that under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, the power of appointment will be treated as a general power of appointment. Basically this provision prohibits exercising a special power of appointment, which is not included in the decedent's gross estate, in such a manner as to extend a trust for a period, which when measured from the initial creation of the trust, would be a violation of the rule against perpetuities. Decedents may intentionally come within this provision so a special power of appointment in a transfer subject to generation-skipping tax becomes a general power of appointment included in the decedent's estate and not subject to a generation-skipping transfer tax. Because this provision is dependent upon state law applicable to the instrument that initially created the special power of appointment being exercised by the decedent, a careful examination of that local law must be undertaken by the preparer to determine if the exercise did or did not fall within the Delaware tax trap.

[G] State law limitations

TAM200014002 points out that the power of appointment must be interpreted according to the law of the state under which the trust is formed. The IRS ruled that because the decedent was precluded by state law from exercising in her own favor a principal distribution provision of a trust of which the decedent was a co-trustee and an income beneficiary, the value of the trust will not be included in decedent's gross estate. This ruling involved Missouri law. Similar rulings were made in Rev. Rul. 54-153,1954-1 CB 185, involving New York law and Rev. Proc. 94-44,1994-2 CB 683, involving Florida law.

§11.05 *Special powers of appointment*

Also called non-general or limited powers of appointment, these require an affirmative answer to Part 4, Question 12b as to whether the decedent possessed "any power, beneficial interest, or trusteeship," and a listing of the interest on Schedule H. Consider setting forth on Schedule H as an attachment your reasons for classifying the interest as a special power rather than a general power. A sound and cogent explanation may avoid an audit, and if the agent is reasonable, may avoid penalties if

it is eventually determined that the power of appointment was general.

[A] "Happiness" prohibited

Watch for powers that permit the trustee to distribute to himself or herself for standards other than "health, education, support and maintenance," such as "happiness." *In C. Berryman Forsee*, 2001-1 USTC ¶ 60,393 (D.C. Kan. 2001), the district court found that distributions for "happiness, health, support and maintenance" was a general power of appointment because there was no trust language that restricted the meaning of "happiness" so as to limit the decedent's power by an ascertainable power related to "health, education, maintenance and support," and Kansas law did not place any restrictions on trustees that limited the extent to which principal can be invaded.

[B] Delaware tax trap

See the subsection above entitled "Delaware tax trap" to see how a special power of appointment by exercise can be turned into a general power of appointment.

§11.06 *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.

§11.07 *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.

12 SCHEDULE I - ANNUITIES

§12.01 *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.

§12.02 *Definitions*

[A] 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. 15. 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 § 2039(e) (before its repeal).

[B] 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. 15.

[C] 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.*

§12.03 *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."

[A] General

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

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

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

c. 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;

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

[B] 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:

[a] Pension, profit-sharing, stock bonus, and other similar plans, and

[b] 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 met all the requirements of IRC § 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 IRC § 403(a).

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

[d] Chapter 73 of Title 10 of the United States Code. 10 U.S.C.A. §§1431-1460 (West 1998).

[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 § 408(a).

[g] An individual retirement annuity described in IRC § 408(b).

[h] A retirement bond described in IRC § 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 § 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 employers 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.

[C] Applicability

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

[D] Amounts excluded

[1] Up to $100,000

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

(1) 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

(2) had separated from service before January 1, 1985, and did not change the form of benefit before death.

[2] Over $100,000

The amount excluded can exceed $100,000 if either:

(1) 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 31, 1982), and the decedent irrevocably elected the form of the benefit before January 1, 1983; or

(2) the decedent separated from service before January 1, 1983, and did not change the form of benefit before death.

[3] Irrevocable elections

Under P.L. 99-514, Section 1852(e)(3), a person separated from service before January 1, 1983 as to the unlimited exclusion or before January 1, 1985, as to the $100,000 exclusion, is treated as having made an irrevocable election and having been in pay status as long as the form of the benefit is not actually changed prior to the individual's death.

[E] Receivable by the executor

Similar to otherwise excludible life insurance that becomes includible in the gross estate when payable to the decedent's estate, an otherwise excludible annuity can become includible.

> If any part of an annuity under a "plan" described in paragraphs **a** - **h** above is receivable by the executor, it is generally includable in the gross estate on [Schedule I] to the extent that it is receivable by the executor in that capacity. 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, p. 15.

[F] Exclusion rules for pension, profit-sharing, stock bonus, and other similar plans

[1] 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 includable in the gross estate.

[2] 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 that 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 § 2039.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 IRC § 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 IRC § 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.

[G] 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 includable. 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 includable. 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 20.2039-4(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. 16.

§12.04 *Amount included*

IRC § 2039(a) provides that the gross estate includes the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement if under the contract or agreement an annuity or other payment was payable to the decedent or the decedent possessed the right to receive the annuity or payment for life or for any period that does not in fact end before death.

[A] Decedent contributions

IRC § 2039(b) provides that the amount includable in the decedent's estate is the portion of the value of the annuity or other payment receivable under the contract or agreement that is attributable to the part of the purchase price contributed by the decedent. 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 includable is $15,000 (3/4 x $20,000).

Instructions, p. 15.

Say the annuity payment is a structured settlement received in settlement of a lawsuit. In TAM 9530002 at issue was an annuity paid to the decedent as a result of a lawsuit brought on his behalf when he was a minor against a manufacturer for an accident involving a gun. Upon the decedent's death, the annuity payments continued for the decedent's mother. The advice stated that the value of the payments remaining at the decedent's death are includible in the decedent's gross estate under IRC § 2039 as payments receivable by a beneficiary by reason of surviving the decedent under any form of contract or agreement. The settlement was based on a cause of action personal to the decedent and the payments compensated the decedent for his personal injuries and belonged to the decedent.

[B] 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. 15.

[C] Not includable

[1] Consideration paid by another

If the consideration for the annuity did not come from the decedent or the decedent's employer, then the annuity need not be included in the estate. IRC § 2039(b).

[2] Cessation at death

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 includable in the gross estate. Social Security benefits are not includable in the gross estate even if the surviving spouse receives benefits. Instructions, p.15. Includable elsewhere

The instructions caution that an annuity or other payment that is not includable in the decedent's gross estate as an annuity may still be includable 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.

[D] 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 includability. There may be good reasons for not taking the marital deduction; however, the automatic marital deduction should not be blindly taken.

§12.05 *Required information*

[A] 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:

[a] if it is under an approved plan.

[b] 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.

[B] 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 IRC § 219 (other than a rollover contribution) to the total amount paid for the account or annuity. *Id.*

[C] 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. Treas. Reg. §20.6018-3(c)(4).

[D] 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.*

[1] 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.* The regulations require more comprehensive information.

> If the executor has not included in the gross estate the full value of an annuity or other payment described in section 2039, he shall nevertheless fully describe the annuity and state its total purchase price and the amount of the contribution made by each person (including the decedent's employer) toward the purchase price. If the executor believes that any part of the annuity or other payment is excludible from the gross estate under the provisions of section 2039, or for any other reason, he shall state in the return the reason for his belief.
> Treas. Reg. §20.6018-3(c)(4).

§12.06 *Valuation of annuities*

[A] Annuities under regulations

The fair market value of annuities as well as life estates, terms of years, remainders and reversionary interests for estates of decedents is the present value of such interests determined under the actuarial factors set forth in the regulations, Treas. Reg. § 20.2031-7(a), except that the value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. Treas. Reg. § 20.2031-8(a).

TAM 9530002 sets forth the IRS position that no discount is available for the possible future insolvency of the payor. In Chapter 10, Miscellaneous Property, under lottery winnings there is a discussion of *Cook v. Commissioner*, 349 F.3d 850 (5th Cir. 2003), and it's key holding that the application of a non-marketability discount is not appropriate for annuities because the limited marketability of annuities has been already factored into the annuity table calculations.

[B] Annuity tables

In valuing an annuity, IRS Publication 1457 contains annuity tables and is available online at http://www.irs.gov/pub/irs-pdf/p1457.pdf.

§12.07 *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).

13 SCHEDULE J - FUNERAL AND ADMINISTRATION EXPENSES

§13.01 *When completed*

Schedule J must be completed if a funeral or administration expense deduction is going to be claimed.

[A] Items to be listed elsewhere

The instructions state, "Do not list expenses incurred in administering property not subject to claims on this schedule. List them on Schedule L instead." Form, Schedule J, p. 24. The term "property not subject to claims" means non-probate property.

> The deduction is limited to the amount paid for these expenses that is allowable under local law but may not exceed:
> 1. The value of property subject to claims included in the gross estate, plus
> 2. The amount paid out of property included in the gross estate but not subject to claims. This amount must actually be paid by the due date of the estate tax return.
> The applicable local law under which the estate is being administered determines which property is and is not subject to claims. If under local law a particular property interest included in the gross estate would bear the burden for the payment of the expenses, then the property is considered property subject to claims.
> Form, Schedule J, p. 24.

Under this language, if the decedent's will allocated funeral and administration expenses to the decedent's revocable management trust and that

allocation is enforceable under local law, then such expenses are deductible on Schedule J.

[B] Items reported on Form 1041

At the top of Schedule J, this direction is given. "If executors' commissions, attorney fees, etc. are claimed and allowed as a deduction for estate tax purposes, they are not allowable as a deduction in computing the taxable income of the estate for Federal income tax purposes. They are allowable as an income tax deduction on Form 1041 if a waiver is filed to waive the deduction on Form 706 (see the Form 1041 instructions)." The instructions state, "Unlike certain claims against the estate for debts of the decedent (see the instructions for Schedule K in the separate instructions), you cannot deduct expenses incurred in administering property subject to claims on both the estate tax return and the estate's income tax return. If you choose to deduct them on the estate tax return, you cannot deduct them on a Form 1041 filed for the estate." Form, Schedule J, p. 24.

A type of expense or a particular item of expense need not be handled the same way. For example some attorney's fees can be claimed as estate tax deductions and other attorney fees as income tax deductions, and a single fee can be split in any manner between an estate or income tax deduction. Treas. Reg. §1.642(g)-2; Rev. Rul. 70-361, 1970-2 CB 133.

The Form 706 preparer will need to review the estate's Form 1041, even if not the preparer of the income tax return. In making such review to extract information, the Form 706 preparer may inadvertently become legally responsible for the accuracy of the Form 1041. The argument by the decedent's personal representative would be that the review of the Form 1041 makes the Form 706 preparer responsible to detect and notify the personal representative of any errors. See discussion in §1.04

Preparer-client relationship, [E] Engagement letter, [3] Scope of the engagement, and discussion of language for inclusion in the engagement letter. When a Form 1041 is received, the Form 706 preparer, who has limited the scope of the engagement to not include review of the Form 1041 prepared by others, should consider sending Letter X1, Form 1041 Review, to the Form 1041 preparer as well as the decedent's personal representative.

Letter X 1
Form 1041 Review

Mr. Manny Count
Count and Company
CPA 433 Maple Street, Suite 30
Dallas, Texas 78999

Re: Form 1041 (Estate of John Q. Sample)

Dear Mr. Count:

Thank you for sending me copies of the Forms 1041, U.S. Income Tax Return for Estates and Trusts, for the Estate of John Q. Sample. We will keep the copy of the tax return in our files for the Estate of John Q. Sample.

Please be advised that this firm does not opine as to the accuracy or completeness of income tax returns prepared by others. Our engagement letter with the Independent Executor specifically excludes from our services the review of income tax returns prepared by others. With this in mind, we gave the return a cursory look and have no suggested changes.

If you have any questions, call me at 210-987-6543.

Very truly yours,

Howers and Billings
By: _____

cc: Richard V. Sample
1313 Ruele
San Antonio, Texas 78229

§13.02 *Funeral expenses*

All funeral expenses claimed are to be itemized on line A, according to the instructions. The instructions also state "List the names and addresses of persons to whom the expenses are payable and describe the nature of the expense." Form, Schedule J, p. 24. Funeral expenses are deductible only on the Form 706 and not on the Form 1041. *Id*. The regulations require for deduction that the amount actually be expended and that it be properly allowable out of property subject to claims under the laws of the local jurisdiction. Treas. Reg. §20.2053-2. As to the first requirement, it is still acceptable to take a deduction for the estimated amount to be spent on a monument even though that amount has not yet been spent. As to the second requirement, if state law imposes the obligation on the spouse, then the expense is not deductible.

[A] Reimbursements

The instructions state that any amount reimbursed is to be deducted from the claimed expense. Form, Schedule J, p. 24. Examples would be reimbursements from a burial policy or prepaid funeral contract, and according to the instructions, the Social Security Administration and the Veteran's Administration. *Id*. A burial policy or prepaid funeral contract need not be reported as an asset of the estate.

[B] No tax on what's not in the estate

The discussion on reimbursements raises the point that the gross estate does not include what goes into the grave with the decedent, provided its not overdone. Your author found the following excellent lay estate tax planning in a will written in 1959:

> I have heretofor arranged with and given written directions to Akers Funeral Home of San Antonio, Texas, regarding the burial of my remains, which include the following details:
> a) that my wedding band with seven (7) diamonds be placed on the ring finger of my left hand;
> b) my ring with three (3) large diamonds and eight (8) small diamonds be placed on my ring finger on the left hand next to the wedding ring;
> c) that my diamond Hamilton Wrist Watch be placed on my left wrist;
> d) my diamond bar pin with thirteen (13) diamonds be pinned in front of my burial gown;
> e) the large pink chiffon handkerchief with the lace border to be placed gracefully in my hands;
> . . . I expressly stipulate that the items set out under this paragraph III (a) through (e) shall not constitute any part of my estate, since I have heretofor contracted with the Akers Funeral Home that they shall be buried with me, . . .

[C] Deductible expenditures

Deductible items specifically listed under the regulations include expenditures for a tombstone, monument, or mausoleum or burial lot for the decedent and the decedent's family and a reasonable expenditure for future care. Treas. Reg. §20.2053-2. Deductible are the cost of transportation of the person taking the body to the place of burial. *Id*. Also deductible will be embalming, purchased burial clothes, cremation, casket, hearse, other services of the undertaker, honorariums to ministers and musicians, flowers and decorations, catering expenses for the traditional after service meal, church rental, security for residence, expenses of wake, cost of opening and closing grave, limousines, newspaper obituary, and thank you notes and postage. Recently, the deduction for expense of a family employee to write and address the thank you notes was challenged on audit but accepted at appeals.

Other expenses, such as travel expenses by anyone other than the chief mourner, are regarded as personal expenses and not deductible for estate tax purposes. The person appointed as executor should conduct estate business during the travel to the funeral to secure deduction as an estate administration expense.

> You know why the "living room" came to be so called? Before 1910, funerals frequently were held in parlors of larger homes. The Ladies Home Journal editors decided that game parlors had a bad image. So they repeatedly referred to the parlor thereafter as the "living room." And funeral arrangers built parlors of their own.
>
> L.M. Boyd Revisited

[D] Unusual funeral expenses

"Ashes To Assets: Cremains Turned Into Diamonds" by Jim Suhr, Associated Press, San Antonio Express-News, December 19, 2004, p. 1AA.

ST. LOUIS -- When William Lucas' mother died nearly 2 years ago, he found an unusual way to keep her memory close at hand.

The general contractor from Kitty Hawk, N.C., had some of "Momma Luke's" ashes converted into three synthetic blue diamonds, each about a third of a carat. One is set into his wedding band.

"The analogies are endless: Mom was radiant in life, a real gem," said Lucas, 50. "I can't express the connectedness I feel with this on my hand."

The diamonds were the work of LifeGem, a 3-year-old company based in suburban Chicago that said it has crafted close to 1000 of the diamonds for about 500 families in a business that's steadily growing.

The company markets the diamonds in several countries, saying they offer a "closeness and mobility" you can't get from the traditional forms of commemoration, a tombstone at a grave or an urn for ashes.

"I think more people are looking for more personal ways to remember somebody," said Dean VandenBiesen, LifeGem's vice president of operations. "Rather than having ongoing mourning for someone's loss, people are wanting to celebrate a life."

Lucas read about LifeGem before his mother's January 2003 death from cancer at age 73. Always frugal, he recalled she initially objected to the cost but acknowledged "once I take my last breath, it matters not."

He fulfilled her wish to be cremated and have her ashes scattered under the azaleas at an Episcopal church in Charlotte, N.C., but kept enough to have the three diamonds made at a total cost of $9,000. Two stones will go to his college-age

daughters after their studies are over; he said.

"I'm so pleased that I went ahead and did it," he said. "I had my doubts and trepidations, but to me these gems are priceless, just like my mother."

LifeGem uses 8 ounces of a person's ashes, typically less than a tenth of a person's total cremated remains, to make a diamond through a process can that can take the few months. Carbon extracted from the ashes is subjected to the extremes of heat and pressure, and the resulting stone is cut and faceted like any gem.

Prices vary from about $2,500 for a quarter-carat to about $14,000 for a full carat, VandenBiesen said.

He said many families request more than one gem, with his company's largest order yet coming from a family that wanted 11. While he declined to provide numbers, he said the privately held company was making a profit, with sales exceeding projections. He said an expansion into Japan in October has resulted in a rush of orders.

In the United States, more mourners could turn to the product as cremation is becoming an increasingly popular option. According to the Cremation Association of North America, the percentage of the dead that are cremated was nearly 28 percent in 2002, and is projected to rise to 35 percent in 2010 and 43 percent in 2025.

Often, LifeGem's orders come through funeral directors. A LifeGem "is a great way to pay tribute to someone's life," said Paul Baue, a third-generation director who has four funeral homes and a crematory in the St. Louis area.

Just last month, a 40-something widower who lost his wife to heart disease in May got what he'd ordered through Baue's funeral service, a 0.35-carat, round yellow diamond made from his late wife's ashes.

"It was beautiful, really pretty," Baue said.

The widower declined to be interviewed for this article, but others are less reticent.

Retired factory worker Ruth Lord of Coon Rapids, Minn., is waiting for a diamond crafted from ashes of her 36-year-old son. He died last year and Lord, who still wears some of her son's clothes around the home to feel he's near, ordered a quarter-carat diamond for a ring in September. The rest of his ashes were spread in Montana, where he once snowmobiled with friends.

"When you lose someone you really love, you miss them terrible. You want them close to you," she said.

Lord said the ring will pass on to her granddaughter when she dies.

Other businesses are developing unusual ways to keep cremated remains. A California company, Creative Cremains, offers custom-designed urns designed to resemble or be used as photo frames, musical instruments and even sports equipment.

Georgia-based Eternal Reefs Inc. has catered to people who in life honored the environment, mixing their remains into concrete and placing them in the water off of any of several states, creating new marine habitats for fish and other sea life. Other businesses are offering to send cremated remains into space or place them in fireworks for folks who want to go out with a bang.

The diamonds, however, appealed to Bill Sefton of Scottsdale, Ariz., when he lost a 27-year-old daughter, Valerie, in 2002 to complications from a stem-cell transplant related to her Hodgkin's disease.

He honored her wishes -- no wake, no funeral, no burial. Just cremation, with each specified family and friend to get some of her ashes.

He said she told him, “Whatever you do, don't put me on a mantle or I'll come back to haunt you."

Still Sefton has paid close to $20,000 to convert some of the ashes into seven diamonds -- six for family and another for Valerie's best friend as a wedding present last summer.

One blue diamond is in Sefton’s wedding ring.

"They're not perfect diamonds; it's not a real pure process," he says. "But they have a lot of fire, sparkle and a lot of character -- great representations of Valerie."

It may be an issue whether expenses for space disposition, fireworks, unique urns, or diamond creation, are reasonable and deductible on the Form 706. If estate funds are used to purchase diamonds from the cremains, are those gifts by the decedent to the family members who ultimately receive them? It would seem that the person with authority to make disposition of the remains makes a gift if the diamonds go to someone other than that person, but the result may be different if the decedent requested such a disposition in the decedent’s will. If estate funds are used to purchase diamonds created from the remains, and the resulting diamonds have a fair market value, then is there a deductible expenditure? It would seem reasonable that the amount of the deduction should be reduced by the fair market value

of the diamonds received in return. The fair market value would seem to be the amount spent for their creation, which would make the expenditure a "wash" for deduction purposes.

This raises another interesting issue as to cremains. If the decedent was a celebrity, would the cremains have a fair market value that should be included in the estate? If a celebrity's cremains were made into diamonds to be given to family, friends, or fans, the diamonds may have a fair market value that exceeds the cost of the diamond creation process.

All of this is merely an interesting academic exercise until the IRS gives some guidance. But, the estate considering such expenditures should proceed with the understanding that the full deduction of such expenses on the estate tax return may not be accepted by the IRS.

[E] Not a community liability

The Texas Probate Code contains a provision, Section 320A, to secure the full deduction of funeral expenses for estate tax purposes.

When personal representatives pay claims for funeral expenses and for items incident thereto, such as tombstones, grave markers, crypts or burial plots, they shall charge the whole of such claims to the decedent's estate and shall charge no part thereof to the community share of a surviving spouse.

Section 320A was enacted after *United States v. Collins*, 399 F.2d 90, 91 (5th Cir. 1968), held that under then existing Texas law, only one-half of funeral expenses were chargeable to the decedent's share of the community estate, and thus only one-half of the expenses were deductible for estate tax purposes.

§13.03 *Administration expenses*

The instructions permit the deduction of expenses incurred in administering property subject to claims. Form, Schedule J, p. 24. The instructions also provide, "List the names and addresses of persons to whom the expenses are payable and describe the nature of the expense." *Id.*

[A] "Administration expenses" defined

Treas. Reg. §20.2053-3(a) states:

> Administration expenses are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, ... Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.

In *Pitner v. United States*, 388 F.2d 651 (5th Cir. 1967)(Texas probate) it was held that administration expenses are deductible for federal estate tax purposes under IRC § 2053 even though the will is not probated and there is no formal administration of the estate.

[1] Necessity requirement

The IRS may disallow deductions for administration expenses incurred solely for the benefit of the beneficiaries or heirs. *Estate of Posen v. Comm.*, 75 TC 355 (1980). Expenses incurred solely for the benefit of the beneficiaries are not necessary. In *Smith's Estate v. Comm.*, 510 F. 2d 479, 481-482 (2d Cir. 1975), the IRS determination that commission expenses were unnecessary and for the benefit of the beneficiaries was upheld.

[2] Necessity as matter of Federal or state law

The circuits are not in agreement as to whether necessity is a matter of state or Federal law. The Sixth Circuit has held that the question of allowability of an expense under IRC § 2053 is solely a matter of state law, and if the expense is allowed in the state probate proceeding, then it must be allowed as an administrative expense deduction under IRC § 2053. *Estate of Park v. Comm.*, 475 F. 2d 673, 676 (6th Cir. 1973). The Seventh Circuit has implicitly followed this view in *Ballance v. U.S.*, 347 F. 2d 419, 423 (7th Cir. 1965) and *Estate of Jenner v. Comm.*, 577 F. 2d 1100, 1106 (7th Cir. 1978).

The Fifth Circuit has taken the view that the regulations under IRC § 2053 properly add a Federal level of inquiry as to the allowance of an expense by the state probate court.

> In the determination of deductibility under section 2053(a)(2), it is not enough that the deduction be allowable under state law. It is necessary as well that the deduction be for an 'administrative expense' within the meaning of that term as it is used in the statute, and that the amount sought to be deducted be reasonable under the circumstances. These are both questions of federal law and establish the outside limits for what may be considered allowable deductions . . . .
>
> *Pitner v. U.S.*, 388 F.2d 651, 659 (5th Cir. 1967).

This view has been followed by the Tax Court and several other circuits. *Estate of Posen*, 75 TC 355 (1980); *Hibernia Bank v. U.S.*, 581 F.2d 741, 744 (9th Cir. 1978); *Estate of Smith v. Comm.*, 510 F.2d 479 (2d Cir. 1975); *Marcus v. DeWitt*, 704 F.2d 1227, 1230-1231 (11th Cir. 1983).

[B] Reasonableness

In the Fifth Circuit, for an expense to be deductible, it must be reasonable under both state and federal law. *Pitner v. U.S.*, 388 F.2d 651, 659 (5th Cir. 1967). In the author's view this is not a separate and distinct test, because any expense that was necessary would seem to be reasonable. One cannot have a necessary expense that was unreasonable.

[C] Expenses of sale

Treas. Reg. §20.2053-3(d)(2) permits deduction of expenses of sale necessary to pay debts, expenses, or taxes, preserve the estate, or effect distributions. Expenses of selling assets, such as broker's commissions on real estate or securities, or the buyer's and seller's premiums on items sold at auction, are deductible "only if the sale is necessary to pay the decedent's debts, the expenses of administration, or taxes, or to preserve the estate or carry out distribution." Form, Schedule J, p. 24. Selling expenses are properly listed on Schedule J and not by reporting the value of the item by deducting selling expenses from the net proceeds. For example, if a residence sells for $200,000 with selling expenses of $15,000, the value reported on Schedule A should be $200,000, not $185,000, and the selling expenses are properly reported as an administration expense on Schedule J. On Schedule J list the schedule and item number where the sold asset is reported. Selling expenses deducted on the estate tax return cannot be taken as a deduction or as an offset against sales proceeds on the fiduciary income tax return. IRC § 642(g). Where property is sold to a dealer or unrelated third party during administration for less than fair market value the loss, meaning the fair market value less the sale price, may be deductible as an administration expense where the sale is necessary to pay the decedent's debts, expenses, or taxes, to preserve the estate or to effect distribution. Treas. Reg. § 20.2053-3 (d). Sales commissions may be deducted only up to the amount of all taxes and administration expenses. *Estate of Smith*, 57 TC 650 (1972), *acq*. 1974-2 CB 4, *aff'd*, 510 F. 2d 479 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975). These permitted reasons for deducting administration expenses may be titled: (i) raise cash, (ii) preserve property, and (iii) complete distributions.

[1] Raise Cash

To prove the appropriateness of the deduction, when the sale is necessary to raise cash, it may be necessary to prepare a cash availability and needs statement. Available cash would include cash and cash equivalents listed on Schedule C and insurance proceeds, listed on Schedule D as paid to decedent's estate. Easily liquidated assets, such as publicly traded stocks and bonds need not be considered cash for such purposes. Cash reported on Schedule E need not be considered available nor cash reported on Schedule G as part of a trust included in the gross estate, unless the trust itself is liable for the taxes or the trust contains a provision mandating payment of debts and estate taxes. Once a liability for the sum of the debts, expenses of administration and taxes is shown to be in excess of available cash, the selling expenses should be deductible. Say you need to raise $5,000 in cash to pay the taxes, and you have publicly traded stocks of $500,000 or a residence worth $300,000. Once there is a need to incur selling expenses, you should be able to raise the funds however the executor chooses, and deduction of selling expenses to sell the residence should be deductible.

Consider stating in the description of a deducted expense of sale, "sale necessary in order to raise cash to pay federal and state estate taxes." Where there is one or just a few, consider attaching the cash availability and needs statement where deductions are substantial.

> TEXAS -- Times are indeed tough when a cowboy's saddle has to be auctioned off to pay his debts. So it is for Roy Rogers. The film star with a trick pony died four years ago and was followed by his wife, Dale Evans, last year. That left the kids with an estate tax bill as big as a horse. To satisfy this "debt" his heirs auctioned off the cowboy's famous ruby, gold and silver encrusted saddle--it fetched $412,000 over the weekend--along with his chaps and gauntlets and silver spurs; 30 items in all. It took 16 craftsmen six months to make that saddle, and five years of negotiating for Rogers to get his hands on it. And only a matter of months for the IRS to get rid of it.
>
> *Wall Street Journal*, January 23, 2002.

In *Estate of Constance R. Grant v. Comm.*, 78 TCM (CCH) 900, selling expenses to sell decedent's residence or repairs to make it saleable, were not deductible because the estate had sufficient cash and "liquid cash type assets" (money market mutual funds, bank checking account, and money market bank account). At issue were deductions on Schedule J as well as Schedule L for assets held in a revocable trust.

[2] Preserve the estate

If the estate has livestock that must be sold because no one is available to care for the livestock, the selling expenses would be deductible. The same is true for any other perishable commodity.

[3] Complete distributions

If the estate does not have sufficient cash to effect pecuniary bequests, selling expenses to raise

the necessary cash should be deductible. Subtle distinctions may separate a situation where the sale was necessary to effect the distribution with selling expenses deductible from a situation where the sale is viewed as for the convenience of the beneficiaries and the expense is not deductible.

[4] Selling expenses not deductible

Selling expenses will not be deductible if the sale is not necessary to pay debts, expenses or taxes, preserve the estate, or effect distribution. Such selling expenses are viewed as being for the personal benefit of the estate beneficiaries. Treas. Reg. §20.2053-3(d)(2). In the Fifth Circuit, the validity of this regulation has been upheld, *Pitner v. U.S.*, 388 F.2d 651 (5th Cir. 1967); while the Sixth Circuit has held that deductibility is purely a question of allowability under local law; *Estate of Park v. Comm.*, 475 F.2d 673 (6th Cir. 1973). Selling expenses not deductible for estate tax purposes should be deductible as administration expenses for federal income tax purposes.

[D] IRS litigation position

If the preparer has a question regarding whether the expense is necessary and reasonable one may review the IRS litigation guideline memorandum outlining factors in determining the deductibility of interest payments by an estate, LGM TL-65.

[E] Double deductions prohibited

Administration expenses can be deducted on the Form 706 or the Form 1041, but not both. There is an excellent discussion in Abbin, *Income Taxation of Fiduciaries and Beneficiaries*, §308, on the best way to handle the deductions for administration expenses:

> Trusts and estates may not twice deduct administrative expenses incurred after the date of death.[2] Expenses that could be properly claimed on both the federal estate tax return (Form 706) and the federal income tax return of the estate (Form 1041) must be allocated to either form or split between them.[3] Generally, the decision to claim administrative expenses as a deduction on the Form 706 or 1041 is based on which alternative yields the greater federal tax savings (income and estate tax combined). It should be recognized, however, that this decision may affect beneficiaries differently. Taking expenses as an income tax deduction will often benefit the income beneficiaries, whereas taking them for estate tax purposes will benefit the residual beneficiaries.
>
> The deduction of administrative expenses on the estate's Form 1041 must be accompanied by a waiver stating that the amounts claimed have not been allowed on the federal estate tax return. [IRC Sec. 642(g).] There is no requirement, however, that the waiver be filed at the same time as the return on which the deduction is claimed. Consequently, a fiduciary may claim a deduction for administrative expenses on both the federal estate tax return and the federal income tax return, provided that an amended return is filed for one of these returns prior to the close of the statute of limitations and no double benefit is obtained.
>
> Further, assuming no waiver has been filed, expenses claimed as income tax deductions (Form 1041) may be reasserted as estate tax deductions (Form 706) should an amended estate tax return be required or modifications be made pursuant to an audit by the IRS. (This assumes that the income tax return would be amended and the deductions would be shown only on the estate tax return.) Note that once the waiver is filed, it is irrevocable and binding. If administration expenses are claimed on an estate's income tax return and a waiver is filed with that return, the fiduciary no longer has any flexibility to later claim these expenses as an estate tax deduction. Accordingly, the best planning posture is to defer filing the waiver as long as possible.

§13.04 *Executors' commissions*

The instructions and the regulations state that commissions may be deducted that have been paid or that are reasonably expected to be paid. Commissions not actually collected are not deductible. Form, Schedule J, p. 24. Treas Reg. §20.2053-3(b)(1).

[A] Amount of deduction allowed

Where the amount of the commissions are not fixed by the probate court, which is the case in states such as Texas with independent administration, the deduction will be allowed on final audit when:

(i) The district director is reasonably satisfied that the commissions claimed will be paid;

(ii) The amount entered as a deduction is within the amount allowable by the laws of the jurisdiction where the estate is being administered; and

(iii) It is in accordance with the usually accepted practice in that jurisdiction to allow such an amount in estates of similar size and character.

Treas. Reg. § 20.2053-3(b)(1). The instructions have a statement similar to the regulations. Form, Schedule J, p. 24.

[2] IRC Sec. 642(g).

[3] It should be noted that the rule against double deductions does not apply to expenses of the decedent (taxes, interest, business expenses, and other items) that were payable at the date of the decedent's death. They are deductible on the decedent's estate tax return as unpaid debts. These are debts of the estate and are deductible either on the decedent's final individual income tax return or on the estate tax return. The double deduction section looks to administration expenses incurred after the date of death.

[B] Amount permitted by state law

TEX. PROB. CODE §241 states the amount of commissions as 5% of cash received, excluding cash on hand or on deposit, and 5% of cash paid, excluding distributions to the beneficiaries, not to exceed 5% of the total gross estate. This may require a cash flow analysis to determine the maximum fee permitted. It may require going to court for approval of a higher fee, as permitted by TEX. PROB. CODE, § 241.

In *Grant v. Comm.,* 78 TCM (CCH) 900 (1999), because most of the estate's assets were in trust, the executor's commissions were limited to the amount permitted for the estate amount subject to administration. This can create a problem in taking an appropriate fee where the executor is responsible for the federal tax administration of an estate but the probate assets are limited. It may not be possible to deduct them on Schedule J, under the reasoning of *Grant*, but the authority to impose a fee on the trust assets for the preparation of the return may be lacking under state law. IRC § 2207A gives authority to seek reimbursement of estate taxes but not tax return preparation fees. *Grant* was affirmed in *Grant v. Comm.*, 2002 TNT 123-13 (2nd Cir. 2002), when the Second Circuit held

> In order for an expense to be deductible under section 2053, it must qualify as an "administration expense"' under both the applicable state law and the federal law as delineated in the Treasury regulations. In so holding, we join the consistent position taken by the other circuits that have examined this issue.

The other circuits identified were the Fourth, *Estate of Love v. Comm.,* 923 F.2d 335, 337-38 (4th Cir. 1991); Fifth, *Pitner v. United States*, 388 F.2d 651, 659 (5th Cir. 1967); Sixth, *Estate of Millikin v. Comm.*, 125 F.3d 339, 344 (6th Cir. 1997); Ninth, *Hibernia Bank v. United States*, 581 F.2d 741, 744-46 (9th Cir. 1978); and Eleventh, *Marcus v. Dewitt*, 704 F.2d 1227, 1229-30 (11th Cir. 1983).

[C] Commissions fixed by will

The regulations permit the will to fix the amount of the executor's commissions, provided the amount does not exceed the compensation allowable by local law or practice. Treas. Reg. §20.2053-3(b)(2). If the will permits a corporate fiduciary to charge its published fee and that published fee exceeds the 5 and 5 commission allowed in the Probate Code, query if the amount that exceeds 5 and 5 is "allowable by local law."

[D] Challenges upon audit

The preparer may find the amount of the executor's commissions challenged upon audit and must provide support. Usually a citation to applicable state law and a calculation of the deducted amount will suffice.

[E] Required declaration

If the commissions claimed have not been paid at the time of examination of the return, a declaration signed under the penalties of perjury that the amount has been agreed upon and will be paid may be required. Form, Schedule J, p. 24. The taxpayer identification number of the executor is required on the declaration. This information is used to review the income tax return of the executor to see if the commissions are properly reported as income. Form 4421 is used to make the declaration.

[F] Compared with a bequest

The deduction cannot be claimed for a bequest made in the will in lieu of commissions. Form, Schedule J, p. 24, Treas. Reg. §20.2053-3(b)(2). On the other hand, the amount of the bequest is not taxable income to the executor. Form, Schedule J, p. 24, contains this note:

> **Note:** Executors' commissions are taxable income to the executors. Therefore, be sure to include them as income in the year received on your individual income tax return.

A surviving spouse serving as executor and as sole estate beneficiary (at least of the source of funds to pay the executor's commissions) would not normally take a commission, which is subject to income tax, because the bequest will not be subject to estate tax. But an executor who is also a beneficiary of the source of funds to pay the executor's commissions, may be ahead to take commissions where the income tax rate (35% highest marginal in 2003 and 2004) is less than the estate tax rates (49% in 2003 and 48% in 2004 before state rates).

[G] Trustees' commissions

The instructions state that trustees' commissions are not to be deducted on Schedule J, but if the trustees' commissions were paid in administering property not subject to claims, they can be deducted on Schedule L. Form, Instructions to Schedule J, p. 24.

§13.05 *Attorney's fees*

Attorneys' fees actually paid or reasonably expected to be paid may be deducted. Form, Schedule J, p. 24. What happens if the estimated attorney's fees are not actually paid? If a good faith estimate was reported on the estate tax return and there is no audit, there appears to be no requirement to notify the IRS by supplemental information that those fees were not in fact paid.

[A] Amount of deduction allowed

If by final audit of the return, the fees have not been awarded by the court, which is often the case in Texas because of independent administration, and paid, they will still be allowed if the Estate and Gift Tax Territory Manager is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable payment for the services performed, taking into account the size and character of the estate and the local law and practice. Form, Schedule J, p. 24.

[B] Contingent fees

Hourly fees, flat fees, or fees as a percentage of the estate may be reasonable, but a contingent fee related to preparing the estate tax return will never be reasonable. Treas. Circular 230 states:

> **§10.28 Fees** (b) *Contingent fees for return preparation:* A practitioner may not charge a contingent fee for preparing an original return. A practitioner may charge a contingent fee for preparing an amended return or a claim for refund (other than a claim for refund made on an original return) if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended return or claim will receive substantive review by the Service. A contingent fee includes a fee that is based on a percentage of the refund on a return or a percentage of the taxes saved, or that otherwise depends on the specific result attained.

A contingent fee based on factors unrelated to preparing the original return may be reasonable, such as the amount of the gross estate.

[C] Required declaration

Attorneys' fees not paid by time of the audit may need to be declared and signed under penalties of perjury by the executor and the attorney that they are agreed upon and will be paid. Form 4421 is used.

[D] Partial allocation to estate

In community property states, the IRS on audit may take the position that some of the attorneys' fees relate to the surviving spouse's one-half of the community property and attempt to limit the deduction to half of the attorneys' fees charged. Do not accept that allocation without challenge. Almost all attorneys' fees are related to the administration of the decedent's estate; the surviving spouse would have not incurred fees had the decedent not died. In *Ray v. U.S.*, 385 F.Supp. 372, 382 (S.D. Tex. 1974) the court allowed 95% of the expenses to be allocated to the estate.

[E] Litigation expenses

Attorneys' fees incurred by beneficiaries incident to litigation to determine their respective interest in the estate are not deductible if the litigation is not essential to the proper settlement of the decedent's estate. Treas. Reg. § 20.2053-3(c)(3), Form, Schedule J, p. 24. It would seem that in most instances such litigation will be essential to the proper settlement of the estate, because determining the proper beneficiaries will be an important aspect of any administration.

Fees incurred to establish the claim of beneficiaries to the decedent's property under an oral contract with the decedent's brother were deductible, because fees were incurred for the purpose of establishing a claim, the validity of one will and the invalidity of a later will. *Pitner v. U.S.*, 388 F.2d 651, 660 (5th Cir. 1967).

The legal cost of the contest to arrive at the right rule of distribution of the estate, even though the matter was settled by agreement, was deductible. *Sussman v. U.S.*, 236 F.Supp. 507, 508 (E.D.N.Y. 1975).

Amounts paid for attorneys' fees by court order as a direct and unavoidable result of proceedings instigated by the decedent's executors to construe the will were deductible even though the attorneys' services also were to the advantage of interest of various residual legatees. *Dulles v. Johnson*, 155 F. Supp. 275, 283 (S.D.N.Y. 1957), *rev'd on other issues*, 273 F.2d 362 (2d Cir. 1959), *cert. denied*, 364 U.S. 834 (1960).

[F] Pre-death fees

Attorneys' fees for pre-death services are debts of the estate deductible under IRC § 2053(a)(3) and are properly reportable on Schedule K. Such fees may also be deductible as deductions in respect of a decedent (under IRC § 691(b)) on the estate's Form 1041.

[G] Post-filing fees

Attorneys' fees and expenses unanticipated at the time of filing the return may be incurred in the event that the government asserts a deficiency or the estate seeks a refund. The regulations allow a deduction for reasonable attorney's fees that are paid in contesting an asserted deficiency or presenting a claim for refund, but the deduction should be claimed at the time the deficiency is contested or the claim for refund is prosecuted, Treas. Reg. §20.2053-3(c)(2), even though not claimed when filing the return.

§13.06 *Interest*

The instructions only hint at the difficulties in determining if interest is deductible.

> Interest expenses incurred after the decedent's death are generally allowed as a deduction if they are reasonable, necessary in the administration of the estate, and allowable under local law.
>
> Form, Schedule J, p. 24.

[A] Estimated future interest

[1] Interest deducted prior to payment

The IRS takes the position that no deduction is permitted for estimated future interest; only interest actually paid is deductible. Rev. Rul. 80-250, 1980-2 CB 278. Interest may be deducted as paid and a claim for refund, if within the applicable statute of limitations, may be filed. Rev. Rul. 78-125, 1978 -1 CB 292.

[2] Reasonable estimation

To be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. Where the interest rate fluctuates, such as the federal interest rate on deferred payments, or there is a possibility that the loan will be prepaid and the total interest owed will not be paid, the interest cannot be deducted until the year of payment. *Estate of Bailly v. Comm*., 81 TC 246 (1983), *subsequent opinion*, 81 T. C. 949 (1983); *Estate of Ephram Hoover*., 49 TCM (CCH) 1239 (1985); *Estate of Bliss Spillar*, 50 TCM (CCH) 1285 (1985); Rev. Rul. 80-250; 1980-2 CB 278; Rev. Rul. 84-75, 1984-1 CB 193.

[3] Prepayment prohibited

Where the funds are borrowed on a term loan with a fixed rate of interest, and there is a prohibition on early repayment, even where all or substantially all of the interest is due in a single payment at the expiration of the loan term, all of the interest may be deducted on the original estate tax return. *Estate of Cecil Graegin*, TC Memo. 1988-477, 56 TCM (CCH) 387 (1988) *cited and quoted with approval McKee v. Comm*., 72 TCM (CCH) 324, 332 (1996). Similar transactions have been approved by the IRS in several private letter rulings, *eg*. 200020011, 199952039, 199903038. In LGM TL-65, 2000 TNT 121-49, the IRS outlined factors in determining the deductibility of interest payments by the estate, stating that deductions for balloon payments will be challenged when there is doubt as to the bona fide nature of the indebtedness, where the liability for interest is not certain or for a reasonably estimable amount, or when a convincing argument can be made that there is no necessity for the borrowing.

[B] On estate taxes

Interest payable to the government as the result of a Federal estate tax deficiency is a deductible administration expense. Form, Schedule J, p. 24. If the executor elects to pay estate taxes in installments and incurs an obligation to the US, the interest may be deductible as an administration expense. Rev. Rul. 78-125, 1978-1 CB 292. The same is true for interest paid to third parties to get the liquidity to pay taxes. But, penalties are never deductible. Form, Schedule J, p. 24.

In Rev. Rul. 81-154, 1981-1 CB 470, the IRS ruled that the interest on a federal estate tax liability is a deductible administration expense to the extent allowable under local law regardless of the reason incurred, but the penalty for failure to pay or the failure to file is not deductible because it is not a necessary administration expense even if allowed as an expense under local law.

Estate of Bahr v. Comm., 68 TC 74, 82 (1977), acq. 1978-2 C. B. 1, found that it was well settled that an estate may borrow money from a private lender to satisfy its federal estate tax liability and deduct the interest incurred on the debt as an administration expense under IRC § 2053 (a)(2).

In Rev. Rul. 84-75, 1984-1 C. B. 193, the IRS ruled that interest on a loan obtained by an executor of an estate is a deductible administration expense, provided the loan was reasonable and necessarily incurred in the administration of the estate, a finding applicable to a loan obtained in order to avoid a forced sale of assets. Because the estate could prepay the loan or default, the amount of interest the estate might pay in the future was uncertain within the meaning of Treas. Reg. § 20.2053-1 (b)(3), the ruling concluded that interest was deductible by the estate only after it accrues and any estimated amount of interest to accrue in the future is not deductible.

Loans that do not permit prepayment and where all future interest is deductible on the estate tax return are called Graegin loans or notes from the leading case of *Estate of Cecil Graegin*, TC Memo 1988-477, 56 CCH TCM 387, which approved their use and the deduction. The projected interest payments were deductible administration expenses where incurred on a loan to decedent's estate to prevent financial loss from a forced sale of assets to pay estate taxes. The interest cost was actually and necessarily incurred since the estate had insufficient liquid assets to pay the estate tax, and because the amount of projected interest was reasonably certain due to the note's prohibition of prepayment.

In PLR 200020011, the IRS ruled that interest attributable to a loan obtained through a commercial lender to pay off federal estate taxes defered under IRC § 6166 is deductible as an administration expense under IRC § 2053 (a)(2), provided that the amount of interest is ascertainable with reasonable certainty and will be paid and is not based upon vague or uncertain estimates. The ruling did not address the fact that the loan could be prepaid, but was in the process of being revised to prohibit prepayment.

In PLR 200449031 the IRS ruled that interest attributed to a bank loan to pay the estate's estate tax

liability for federal and state estate taxes was deductible as an administration expense under IRC § 2053(a)(2) if it was determined that the loan was necessary for the administration of the estate. The estate included under IRC 2044 a QTIP trust and it would seek reimbursement from the trust the tax for its inclusion in the estate. The estate and the trust liquidated a substantial portion of the estate's assets to pay the estate tax liability.

Steve Akers gives this example that illustrates the power of the tax savings from leveraging the interest deduction.

> The economics of this up-front deduction can be staggering. For example, assume a $10 million taxable estate. If sufficient lifetime gifts have been made so that the estate is in a 47% bracket, the estate would owe $4.7 million in estate taxes. However, assume the estate borrows $1.515 million from a closely-held company under a 15 year note, at 12.0% interest, with a balloon payment at the end of the 15 year period. The accumulated interest payment due at the end of the 15 years would be $6.78 million. Under the Graegin analysis, the interest expense would be currently deductible, yielding a taxable estate of $10 - $6.78 or $3.22million, which would result in a federal estate tax (at a 47% rate) of $1.515 million. The $6.78 million of interest would be paid to the company (which in turn, is owned primarily by family members.) The overall result is a very considerable estate tax savings. **The estate tax that is due 9 months after the date of death is reduced from $4.7 million to a little over $1.5 million.** (However, the interest income would be subject to income tax over the 15-year period.)

These tax savings have caused the IRS to look askance where the lender is closely related to the estate. In TAM 200513028 the decedent and his spouse formed a partnership and the decedent gave 90 percent of his assets to the partnership and the spouse gave cash. The decedent transferred an interest to his child. When the decedent and the spouse got a divorce, the decedent bought out the spouse's interest. The decedent died about five and a half years after the partnership was formed. All estate taxes were paid from the residue, which passed equally to the decedent's two children. The residue consisted mainly of the decedent's 99 percent interest in the partnership. The partnership lent funds to the estate as evidenced by a promissory note, and the estate claimed a deduction on the estate tax return under IRC § 2053(a) for the interest to be paid on the due date of the note. The national office disallowed the deduction, because the parties have virtually identical interests in the estate and partnership, there is no change in the relative net worth of the parties as a result of the loan transaction. The loan transaction has no financial impact aside from the estate tax effect if the interest is allowed as a deduction and under these circumstances, the interest does not constitute a deductible administration expense under IRC § 2053(a), according to the national office.

Another example where the IRS is attacking the estate tax savings available in the interest deductions can be found in *Dorothy Rupert v. US*, USDC Pa., No. 1: CV-03-0421. The decedent won a $13 million lottery paid in 21 annual installment of about $630,000 each. Decedent created a trust to help fund the expected estate tax that would be due on the balance of her winnings and died about six years into the payments. The discounted present value of the unpaid lottery winnings came to some $5.5 million at her death, and she had other assets worth $1.4 million, $1 million of that in cash, resulting in a federal estate due of more than $3 million. The estate borrowed $1.7 million from a bank and claimed an administrative expense for the interest on that loan. The IRS argued that the right to the future payments could have been sold, making the loan unnecessary. The district court ordered the estate to come up with evidence that the loan produced the best result for the beneficiaries.

The interest will be income to the receipient and subject to income tax. Run the numbers comparing the net interest income and the income tax cost with the estate tax savings.

[C] On installments

Interest payable on estate tax installments elected under IRC § 6166 is not deductible by statutorial prohibution. IRC § 2053 (c)(1)(d).

[D] On income tax

Post death interest paid on income tax deficiencies incurred by the decedent may be deducted on the estate tax return as an administration expense. The executor may waive the deduction on the estate tax return and take the deduction on the fiduciary income tax return. Rev. Rul. 69-402, 1969-2 CB 176.

[E] Pecuniary bequests

The law on deducting interest on pecuniary bequests may be somewhat unsettled, with the deduction dependent upon whether the bequest itself is deductible for estate tax purposes.

In *B. Turner Ind. Executrix*, 2004-1 USTC ¶ 60,478 (Dist. N.Tex 2004) a U.S. district court held that statutory interest paid by an estate on a 10 million charitable bequest was deductible as an administrative expense under IRC § 2053 because the expense was actually and necessarily incurred in the administration of the decedent's estate and was allowable under Texas law. The will made a bequest provided that the organization was a charitable

organization under IRC § 2055a and over a three year period the executrix attempted the verify the tax exempt status. Interest accrued at six percent on the bequest one year after date of death under Texas law, but no interest was deducted on the return. After audit and receiving a closing letter, within two weeks, the executrix paid the bequest and $1.05 in interest. The executrix filed suit to obtain an estate tax refund. The court found for the executrix that the interest was unnecessarily incurred in administration because the will specifically required the executrix to verify the organizations charitable status before funding the bequest, the executrix acted prudently in waiting to receive the closing letter before funding the bequest, and the statutory interest was mandated by state law. The element of verification of the exempt status would not be present where the pecuniary bequest passed to a non-charitable beneficiary.

In LTR 9604002 the IRS has ruled that under Pennsylvania law interest paid on the distribution of a non charitable pecuniary bequest is not a deductible expense of administration, rather serving as a substitute for income that the beneficiary would have received on the bequest. "[P]ayment of statutory interest should no more be viewed as an administration expense deductible under Section 2053 than should the payment of estate income to estate beneficiaries." The IRS probably would rule similarly under any other state's law as to a non-charitable pecuniary bequest.

§13.07 *Miscellaneous expenses*

[A] In general

Deductible as miscellaneous expenses are court costs, accountants' fees, appraisers' fees, and clerks. Treas. Reg. §20.2053-3(d). Also, deductible are costs of storing or maintaining assets of the estate. Form, Schedule J, p.24. In addition, typical expenses may include fees to publish notice to creditors, costs to maintain residence (security service, caretakers, utilities, insurance, pest control and grounds maintenance), recording fees, bank service charges, and insurance. It seems that moving expenses are related to distributing the estate, although no ruling or case is known to the author.

[B] Deductible expenses defined

The regulations set forth the language under which an expense must fall in order to be deductible.

> Expenses necessarily incurred in preserving and distributing the estate are deductible, including the cost of storing or maintaining property of the estate, if it is impossible to effect immediate distribution to the beneficiaries ... nor will such expenses be allowed for a longer period than the executor is reasonably required to retain the property.
>
> Treas. Reg. §20.2053-3(d)(1).

The key words are "preserving" and "maintaining" and creativity on the part of the preparer may find a rationale for making an expense deductible.

In *Estate of Constance R. Grant v. Comm.*, 78 TCM (CCH) 900, the tax court permitted under IRC § 2053 regulations for additional death certificates, safe deposit box rental, postage, and insurance on decedent's residence, as well as certain expenses incurred in maintaining that residence, including certain utility expenses such as telephone, home heating fuel, and electricity. Disabuse yourself of the notion that these expenses never go under a microscope, by reading footnote 19:

> Schedule L shows electric bills at decedent's residence for the period May 19, 1994, through Sept. 20, 1994, totaling $1,197.41. For example, the electric bill for the period May 19, 1994, through June 21, 1994 was $356.24, and the electric bill for the period June 21, 1994, through July 22, 1994, was $451.52. Although the periods to which those bills relate covered late spring and early summer 1994, there is no explanation in the record why those bills were so high. One possible explanation is that someone was living at the house during those periods. Without further explanation as to why it was necessary to incur such high electric bills during the period May 19, 1994, through Sept. 20, 1994, the Court will allow only $100 per month for each of the four months of electric bills covered by that period, or a total of $400. The Court will allow in full the amount of the remaining electric bills that were not conceded by respondent.

The problem here is how matters were supported in audit and at the Tax Court. It would appear that utility bills for someone to live at the residence would be the best security possible for the residence.

[1] Storage expenses

Compare Treas. Reg. §20.2053-3(d)(1), quoted above, with Treas. Reg. §20.2031-6(c) which requires obtaining approval of the district director to sell or distribute household goods prior to investigation (audit). Because the code imposes personal liability on an executor who makes a distribution prior to satisfying all taxes, it is arguable that all expenses of storing and maintaining the property during administration prior to receiving a closing letter are reasonable.

In *Estate of Marguerite Millikin v. Comm.*, 69 TCM (CCH) 3032 (1995), expenses incurred to maintain and sell the decedent's residence after distribution of her personal property were not deductible as administration expenses. Under applicable state (Ohio) law an estate was allowed to pay administrative expenses which were necessary, reasonable and just. The governing instrument of the

marital deduction trust that contained the residence at the time of the decedent's death provided that after death the residence was to be transferred to another trust. Instead of transferring it, however, the estate decided to keep it in the marital deduction trust until it could be sold. Because there was no reason why the residence could not have been transferred to the second trust after distribution of the personal property which it contained, the expenses of maintaining the property until it could be sold were not necessary and, thus, not property paid by the estate. This case was appealed to the Sixth Court and affirmed, 79 AFTR 2d 97-940. The appeals opinion has a brief discussion of the distinction between Schedule J and Schedule L deductions.

[2] Travel expenses

Under Texas law your author has successfully obtained on audit deductions for an out-of-state executor and her husband to travel to Texas and stay for extended periods at a destination resort to administer her late father's estate. Texas law is quite broad in determining what is reasonable. But see *Estate of Constance R. Grant v. Comm.*, 78 TCM (CCH) 900, where the Tax Court found that the estate failed to establish that travel expenses from Vermont and New Hampshire to Maryland were necessarily incurred in preserving and distributing the estate's assets. The Court noted that the Maryland attorney general had determined on prior occasions that incidental expenses incurred by non-resident executors in the ordinary business of administering an estate in Maryland, including long distance telephone calls, hotel expenses, and airplane tickets, will not be considered necessary expenses to protect the estate if incurred only because the residents are non-residents.

[C] Estimated expenses

The estate may deduct an estimated amount if the amount of the expense is ascertainable with reasonable certainty and will be paid. The decedent's estate may not claim a deduction if the amount of the expense is vague or the estimate of the expense is uncertain. Treas. Reg § 20.2053-1(b)(3).

The U.S. Court of Federal Claims in *Estate of Snyder v. U.S.*, 84 AFTR2d 99-5963 (Fed. CI. 1999), held that administration expenses may exceed the value of the probate estate. The decedent's assets were primarily held in a revocable trust, including a landfill designated as a superfund site. The real property was worth $3 million, but the estate estimated the clean up expenses at $15 million, later increased to $30 million. The estate later settled with the EPA for $750,000, which the IRS did not want to allow because it exceeded the value of the probate estate. The court held that the expenses were not limited to the probate estate, but applied to property includable in the gross estate of the decedent.

§13.08 *Limitations*

[A] In excess of value

By IRC § 2053(c)(2) the amount deducted cannot exceed the value at death of the property subject to claims, except to the extent the deductions are amounts paid before the due date of the estate tax return.

[B] Will contest settlements

Sums paid out of the gross estate assets to settle a will contest are not deductible under IRC § 2053 as an administration expense because payments to contestant are in satisfaction of a claim to share in the estate, which is not deductible from the gross estate. *Estate of Lydia Moore*, 54 TCM (CCH) 1167, 1168 (1987).

[C] Certain taxes

By IRC § 2053(c)(1)(B), an amount otherwise deductible cannot be deducted if it represents income taxes on income received after the death of the decedent, property taxes not accrued before death, or any estate, succession, legacy, or inheritance taxes. Property taxes that accrue after death, on property that is administered by the estate, may seem to be a reasonable expense of administration, but by IRC § 2053(c)(1)(B) those taxes cannot be deducted.

In TAM 200444021 the national office ruled that under IRC § 2053(c)(1)(B) income taxes paid by the estate on the estate's income tax return with respect to distributions to the estate from individual retirement accounts used to pay the decedent's estate taxes were disallowed deductions.

[D] Certain death taxes after 2004

After 2004, the state death tax credit will be reduced to zero and replaced by a deduction for state death taxes, under new IRC § 2058, which states:

> (a) Allowance of deduction. -- For purposes of the tax imposed by Section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent).

The deduction does not apply to foreign death taxes and the deduction is of no significance for a taxable estate less than the applicable exclusion amount. No limit is imposed on the amount of state death tax that can be deducted by the estate of a citizen or resident.

14 SCHEDULE K - DEBTS, MORTGAGES AND LIENS

§14.01 *When completed*

Schedule K must be completed if any debts or mortgages are to be claimed on the return.

§14.02 *Debts*

Unsecured debts are listed on the first part of Schedule K.

[A] Limited to valid debts

Only valid debts the decedent owed at the time of death may be deducted. Treas. Reg. §20.2053-4.

A settlement payment of a claim of tortious interference with inheritance did not constitute a deductible claim against the estate because it did not represent a personal obligation of the decedent existing at the time of his death. *Lindberg v. U.S.*, 164 F.3d 1312, 1318 (10th Cir. 1999).

An unenforceable debt due to the running of the statute of limitations cannot be deducted. See TEX. PROB. CODE §289(b) which prohibits a personal representative paying an unenforceable debt. Other states may have similar laws.

A consent decree before a local court will be accepted as a basis for an estate tax deduction:

> The decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends....It must appear that the Court actually passed upon the merits of the claim. This will be presumed in all cases of an active and genuine contest.
>
> Treas. Reg. '20.2053-1(b)(2).

[B] Amounts in controversy

If the amount of the debt is disputed or is the subject of litigation, only the amount the estate concedes to be a valid claim may be deducted. The amount in contest is to be listed in the appropriate column. Instructions, p. 16. The consequence of failing to list the contested amount has of yet not been the subject of a ruling or litigation.

This may pose a very mundane question. How do you handle decedent's credit card debt on which the executor successfully convinces the credit card company to accept less? Do you list the whole debt as of the date of death or just the amount that satisfied the credit card company?

[1] Post death facts considered

An estate tax deduction for a decedent's income tax liabilities was reduced by the amount of an income tax refund that the estate subsequently received. The Tax Court considered post-death events that affected the decedent's income tax liability. A claim that is valid and enforceable at the date of a decedent's death must remain enforceable in order for the estate to deduct the claim and technical claims that disappear in the light of subsequent circumstances should not be allowed, according to the Tax Court. *Estate of Evelyn McMorris v. Comm.*, 77 TCM (CCH) 1552 (1999).

[2] Post death facts ignored

The IRS has announced nonacquiescence with *Estate of Smith v. Comm.*, 198 F.3d 515 (5th Cir. 1999); AOD 2000-04. The Fifth Circuit held that information known or available up to, but not after, the date of a decedent's death should be considered in determining the amount deductible under IRC § 2053 for a contingent or contested claim against a decedent's estate. The proper amount of the deduction was the fair market value of the claim on the decedent's date of death. The estate deducted an oil company claim for reimbursement from the decedent of oil royalties paid her on amounts that the company was ordered to refund to the federal government.

On remand to the Tax Court, TC Memo 2001--303 (CCH Dec. 54,548 (M)), the court rejected the estate's argument that it was entitled to deduct the amount that the oil company sought from the decedent and accepted the testimony of the IRS expert that the value of the claim was less than the amount sought from the decedent prior to her death. In valuing the claim, the expert assigned mathematical probabilities to: (1) whether the royalty owners would be held liable; (2) whether the oil company would be able to recoup a base amount; and (3) whether it would be able to recoup pre-judgment and post judgment interest. The expert did not discount the claim for the time value of money. The expert also calculated the amount of income tax benefit under IRC § 1341, which allows an income tax deduction to a taxpayer who previously received taxable income under a claim of right, but who must later repay some or all of that income. The court of appeals said that determining the income tax benefit was a "simple mathematical deduction." Here it made no difference because the amount before the IRC § 1341 adjustment was lower than the amount of the deduction in the notice of deficiency and the IRS did not reduce the IRC § 2053 deduction below the amount in the notice of deficiency.

In Rev. Rul 75-24, 1975-1 CB 306, and Rev. Rul 75-177, 1975 CB 307, as to Mississippi and

Florida state law respectively, ruled that a deduction could be taken for a debt for which no timely probate claim was filed if the debt were paid during the time period for filing claims and the personal representative could not be surcharged for paying the claim. Under Mississippi law the personal representative could not be surcharged if the beneficiaries approved payment of the claim, but Florida law recognized no such exception for beneficiary approval and the claim could not be deducted on the estate tax return.

Estate of McMorris v. Comm., 243 F.3d 1254 (10th Cir. 2001), involved federal income taxes shown owing on decedent's final return for which a refund was eventually issued. Decedent received from her previously deceased husband closely held stock valued at $23 million, which she sold for $29.5 million, and her estate reported $4.6 million deduction for taxes on the estate tax return. In auditing the husband's return the value of $33.5 million was argued for the stocks. Decedent's estate filed for a refund on income taxes and in the litigation with the IRS on an unrelated item filed an amended answer asserting a deficiency in estate taxes based upon the reduction in the income tax liability. In TC Memo 1999-82 the tax court agreed with the IRS. The Tenth Circuit held that events which occur after the decedent's death may not be considered in valuing the deduction, resulting in a windfall for the estate.

Estate of O'Neal v. U.S., 88 AFTR2d & 2001-5245,258 F.3d 1265 (11th Cir. 2001), ignored post-death events in a case involving the actual settlement amount the decedent owed transferees for transferee liability for gift, GST tax, penalties and interest. The actual liability was not resolved until after the transferor's death. The circuit court instructed the district court neither to admit nor consider evidence of post-death occurrences when determining the date of death value of the claim. The estate and the government must present the district court with relevant evidence of *pre-death* facts and occurrences supporting the date of death value of the deduction.

Other courts that have addressed the IRC § 2053(a)(3) issue where the claim is contested, contingent, or unenforceable on the date of death, considered post-death events in determining the allowable deduction. *Gowetz v. Comm.*, 320 F.2d 874, 875 n. 1 (1st Cir. 1953), aff'g sub nom., *Estate of Taylor v. Comm.*, 39 TC 371 (1962); *Estate of Sachs v. Comm.*, 856 F.2d 1158 (8th Cir. 1988) (IRS allowed to reduce claim against estate for the decedent's income taxes resulting from retroactive tax forgiveness legislation enacted four years after decedent's death.); *Estate of Courtney v. Comm.*, 62 TC 317 (1974); *Estate of Charles Cafaro*, TC Memo. 1989-348. *See also, Estate of Van Horne*, 720 F.2d 1114 (9th Cir. 1983) and *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982). *But cf., Comm. v. Strauss*, 77 F.2d 401 (7th Cir. 1935). *A. Smith Estate* will still be followed by the IRS in the Fifth Circuit.

FSA 200217022, issued April 26, 2002, states the Commissioner's position that "post-death events are controlling in determining the amount that may be deducted as a claim against the estate whether or not the claim is contested or contingent," and gives the Commissioner's case support for that position. The particular field service advice involved an estate of a decedent killed in an automobile accident in which another driver died. The Service stated that the estate could not deduct the higher amount that the other driver's family made the subject of a claim against the estate but rather was limited to the lesser amount actually paid in settlement to the driver's family.

[3] Contingent liabilities

The estate may be liable on a debt or for a tort but the liability is at issue at death as is the amount owed, if any. Say the decedent is a defendant in litigation on the date of death. The amount of the potential liability can be set forth in the middle column of Schedule K headed "Amount in contest." Listing it in the column "Amount claimed as deductible" could be taken as an admission against interest, unlike a statement that it was in contest. Once the actual amount of the liability is fixed, the estate can file a claim for refund. To avoid the statute of limitation expiring, file the claim for refund after close of the audit and leave the claim dormant at the trial level until the liability issue is resolved.

[4] Horns of a dilemma

The preparer may be tempted to state the estate's liability in negative yet certain terms to assure the deduction, but can the representations made on the estate tax return be discovered by the opposition in the litigation? Preparers need to avoid statements against interest that can harm them in the litigation.

[5] Duty to supplement

A related issue is whether as a result of post-death events the estate has a duty to file supplemental information. This question will only arise where the post death events cause a decrease in the reported deduction, because the estate will be motivated by a tax refund to report post death events that result in an increased deduction. It may be that the duty to amend does not arise where the claim as originally valued was valued in good faith based on the facts at the date of death and known at the time of preparing the return. The preparer should consider employing litigation counsel for the purpose of

evaluating the likely liability on that claim. But see above as to whether that evaluation can be discovered by the plaintiff in the litigation. See discussion in "Amending returns and claims for refund," in Chapter 1, "General Matters."

[C] Bona fide requirement

If the claim is based upon a promise or agreement, the deduction is limited to the extent that the liability was contracted bona fide and for an adequate and full consideration in money or money's worth. IRC § 2053(c)(1)(A); Instructions, p. 16.

[1] Lack of consideration

A promise or agreement, even a signed promissory note, unsupported by consideration, is not deductible.

In *L. Cavett Estate,* 79 TCM (CCH) 1662 (2000), the tax court concluded that bequests made to the companion in the decedent's will could not be recharacterized as a claim against the estate on the basis of a prior written agreement between the decedent and the companion. The estate contended that bequests to the companion were payments for past services, offering an Agreement to Make a Will, in which the decedent agreed to leave certain property to his companion as consideration for her past and future services. The court concluded that the agreement signified the decedent's desire to protect his companion from a will contest. The estate failed to prove the value of the future services to be rendered by the companion, that it was the agreement that motivated the decedent to provide for his companion, in his will, or that any obligation imposed on the decedent by the agreement was for adequate and full consideration.

Could the estate deduct the obligation on a note where the decedent borrowed money from the payee, after first making an annual exclusion gift to the payee? The step transaction doctrine would probably come into play and the deduction denied for lack of consideration. *See, Estate of Flandreau v. Comm.*, 72 AFTR2d, 93-6711 (2d Cir. 1993).

[2] Charitable pledges

A promise to make a gift to a charitable organization described in IRC § 2055 is treated differently than a promise unsupported by consideration to persons not described in IRC § 2055. A promise to make a gift to an organization described in IRC § 2055 can be deducted as a claim to the extent that a deduction under IRC § 2055 would be available if the promise or agreement was instead a bequest. IRC § 2053(c)(1)(A). Instructions, p. 16.

[3] Former spouses and others

Payments made to an ex-spouse pursuant to a marital property settlement agreement will be considered as made for full and adequate consideration. IRC § 2053(c)(1)(A) and 2043(b)(2), and 2516. According to the instructions, for such claims to be deductible, all of the following conditions must be met:

- The decedent and the decedent's spouse must have entered into a written agreement relative to their marital and property rights.
- The decedent and the spouse must have been divorced before the decedent's death and the divorce must have occurred within the 3-year period beginning on the date 1 year before the agreement was entered into. It is not required that the agreement be approved by the divorce decree.
- The property or interest transferred under the agreement must be transferred to the decedent's spouse in settlement of the spouse's marital rights. Instructions, p. 16.

A claim made against an estate by a remainderman relating to Section 2044 (QTIP) property is not deductible. Instructions, p. 16.

In *Estate of Kosow*, 45 F.3d 1524, 1531 (11th Cir. 1995), the Eleventh Circuit reversed the Tax Court and held that amounts paid by the decedent's estate to two children from a prior marriage were deductible as claims supported by full and adequate consideration. The children's mother, in a divorce settlement agreement, bargained for the decedent's promise to leave such a bequest instead of seeking higher levels of spousal and child support at the time of divorce.

In a similar case the tax court held that the estate was not entitled to summary judgment because the estate failed to establish that it was entitled to deduct the value of the decedent's children's remainder interest in the decedent's closely held stock as a claim against the estate. *Estate of Edwards v. Comm.*, TC Memo 1997-443. A claim founded on a divorce decree is a liability imposed by law and therefore deductible under IRC § 2053, but the claims of the decedent's children, according to the tax court, were not founded upon the divorce decree but the property settlement agreement.

FSA 1999-1225 does not follow the above analysis and concludes that because the ex-husband did not receive consideration for the promised transfer of property, the ex-wife's claim to his assets was not deductible. Curiously, no mention is made of IRC § 2043(b)(2), and relies on the requirement prior to enactment of that section, which permitted the deduction only when the property settlement agreement was incorporated in the divorce decree.

In *Trompeter* v. *Comm.*, TC Memo 1998-35, the Tax Court disallowed the estate's $1.5 million deduction for settlement it allegedly entered with decedent's ex-wife, who was the mother of the co-executors, finding that there was no bona fide controversy between adverse parties.

> [W]e find that the State court proceeding did not involve a real and bona fide controversy between adverse parties, and that the superior court's decree was not the result of its consideration of the merits of the [ex-wife]'s claim....the co-executors' actions during the State court proceeding were more akin to daughters trying to share inherited wealth with their parent at the expense of the tax collector, than a party suing another in a truly adversarial proceeding in a court of law. As a point of fact, the co-executors did not investigate or legitimately challenge the validity of [the ex-wife]'s claim before they let their mother receive a significant part of the decedent's estate.

For a deduction to be recognized in such a circumstance, the controversy must appear real to third parties.

[4] Will contest settlements

Amounts paid to contestants to settle a will contest for breach of contract to make a will are in satisfaction of a claim to *share in* the estate as distinguished from a claim *against* the estate within the meaning of IRC § 2053(a)(3). *Estate of Lazar v. Comm.*, 58 TC 543, 552 (1972). Will contest settlements are not deductible. The court's acceptance of the facts of a reciprocal will agreement did not rise to the level of a bona fide contract and did not support a deduction under IRC § 2053 for estate settlement payments in *Estate of Huntington v. Comm.*, 16 F.3d 462 (1st Cir. 1994).

[D] Limitations

IRC § 2053(c)(2) states a financial limitation that the deduction cannot exceed the amount available to pay the claim.

> (2) LIMITATIONS APPLICABLE ONLY TO SUBSECTION (a).--In the case of the amounts described in subsection (a), there shall be disallowed the amount by which the deductions specified therein exceed the value, at the time of the decedent's death, of property subject to claims, except to the extent that such deductions represent amounts paid before the date prescribed for the filing of the estate tax return. For purposes of this section, the term "property subject to claims" means property includible in the gross estate of the decedent which, or the avails of which, would under the applicable law, bear the burden of the payment of such deductions in the final adjustment and settlement of the estate, except that the value of the property shall be reduced by the amount of the deduction under section 2054 attributable to such property.

[E] Information reported

The Instructions, p. 16, require the following information:

> a. Include the nature of the debt and the name of the creditor.
>
> b. If the claim is for services performed over a period of time, state the period.
>
> c. For notes unsecured by mortgage or other lien give the name of payee, face and unpaid balance, date and term of note, interest rate, and date to which interest was paid before death.
>
> d. If the amount of the claim is the unpaid balance on a contract to buy property, give the schedule and item number where the property is listed.

[F] Amount deductible

[1] Joint liabilities

If the claim is a joint responsibility, full facts must be given and the responsibility of the co-obligor stated. Instructions, p. 18. Only the obligation of the decedent may be deducted.

[2] Community liability

If the obligation was a community liability, an undivided one-half may be deducted and the surviving spouse's community property liability is not deductible.

[3] Probate assets limitation

In *Estate of Snyder v. US*, 84 AFTR2d Par. 99-5255 (Ct. Fed. Cl. 1999), the government made the argument that the language in IRC § 2053(c)(2) limits the deduction to the amount of property in the probate estate and does not include property in the decedent's revocable trust. The court rejected that argument, finding that the plain language of the statute does not limit deductions to the amount of the probate estate alone.

[G] Double deductions

Generally, items deducted on the estate tax return are not deductible on the fiduciary income tax return, but there are exceptions for decedent's unpaid state and local taxes, interest, various business expenses and alimony that predate the decedent's date of death.

[H] Guarantees

Under Rev. Rul. 84-42, 1984-1 CB 194, when the decedent has guaranteed another's loan, for the debt to be deductible, the guarantee must have been called on before death and the decedent must have made loan payments. It would appear that amounts called upon post-mortem should also be deductible.

[I] Unsecured notes

Notes unsecured by mortgage or other lien are to be listed with full details, including name of payee,

face and unpaid balance, date and term of note, interest rate, and date to which interest was paid before death. Instructions, p. 18.

[J] Claims information

For each debt, the exact nature of the claim as well as the name of the creditor are to be listed. A claim for services performed over a period of time is to include the period covered by the claim. Instructions, p. 18. The Instructions give this example:

Edison Electric Illuminating Co., for electric service during December 2002, $150.

[K] Balance due on purchase

A claim for unpaid balance due on a contract for the purchase of any property included in the gross estate, should indicate the schedule and item number where the purchased property is reported. Instructions, p. 18.

§14.03 *Taxes*

[A] Income taxes

Unpaid income taxes accrued through the date of death are deductible on Schedule K. The total liability must be reduced by estimated payments made during decedent's life. Taxes on income earned after the date of death are not deductible. IRC § 2053(c)(1)(B); Treas. Reg. §20.2053-6(f). Instructions, p. 18.

[1] Deductions in respect of a decedent

The flip side of income in respect of a decedent are deductions in respect of a decedent, which are expenses accrued by the decedent prior to death which are not deductible on the decedent's final income tax return. They are deductions in respect of a decedent to the extent they are attributable to income-producing assets. Such expenses may be deducted for both estate tax and income tax purposes.

[2] Joint income tax returns

Where the decedent and spouse file joint returns, the amount of income tax liability deductible on the estate tax return is the amount that the decedent's estate would be liable under state law vis-a-vis the spouse after enforcement of any effective right of reimbursement or contribution. There is a rebuttable presumption that the decedent's amount is the joint tax liability times a fraction the numerator of which is the decedent's tax liability as if decedent filed separately and the denominator of which is the combined liability if both spouses filed separately. Treas. Reg. §20.2053-6(f). This should only be applicable to Texas and other community property state decedents where there is a marital property agreement.

[3] Innocent spouse relief

Previously, caution is in order in deciding to reduce an income tax liability deduction in anticipation of innocent spouse relief. In FSA 200117005 the IRS concluded that an executor could pursue a claim for innocent spouse relief only if it had been initiated by the decedent before death. Yet, in *Hale Exemption Trust v. Comm.*, TC Memo 2001-89, the executor was given the authority to initiate the action on behalf of the deceased spouse. Finally, in Rev. Rul. 2003-36, IRB 849 the IRS ruled that an executor of a decedent's estate has authority to request innocent spouse relief as long as the decedent has satisfied any applicable requirements while alive and does not require that the decedent initiate the relief during life.

[B] Property taxes

The deduction for property taxes is limited to taxes accrued before the date of death. IRC § 2053(c)(1)(B); Instructions, p.14. Property taxes, to the extent deductible, are properly deducted on Schedule K and not Schedule J.

In Texas for example, taxes are assessed on January 1 of each year and they must be paid on o before January 31 of the next year. If the taxes have not been paid for the prior January 1 assessment, those taxes may be deducted. For decedents dying in January, who have not paid the prior year's taxes, the estate may be able to deduct property taxes for two years. If property taxes are not yet paid and not yet due, they still may be deducted on Schedule K. For property located in other states, research when taxes are assessed on real property.

[C] Federal gift taxes

Unpaid federal gift tax liability should be deductible as a claim. In *Estate of O'Neal v. U.S.*, 84 AFTR2d 99-7088 (D.C. Ala. 1999), the district court held that a decedent's estate is entitled to a deduction for claims against the estate for gift taxes paid by the heirs and reimbursed by the estate, even though the IRS had never assessed those taxes against the decedent, because the heirs had valid and enforceable claims against the estate.

[D] Limited death tax deduction

IRC § 2053(d) permits an election to take a deduction of certain death taxes assessed by a state or foreign country on property transferred by the decedent for public, charitable, and religious uses described in IRC §s 2055 and 2106(a)(2). There are limitations set forth in the code and the regulations. The IRS will compute the amount for the preparer. Instructions, p. 18.

[E] Interest and penalty

Both interest and penalties on taxes owed by the decedent should be deductible on this schedule, although it is difficult to find clear authority for the deduction, particularly of penalty. Rev. Rul. 71-56, 1971-1 CB 404, permitted under the doctrine of equitable recoupment, a barred overpayment of Federal estate tax to be applied against outstanding assessments of income tax owed by a decedent for years preceding this death. The ruling said that for purposes of determining the amount of estate tax available for equitable recoupment, the estate tax needed to be recalculated with the allowance of the income tax deficiency as a claim against the estate, and the maximum allowable marital deduction needed to be recalculated to reflect the reduced "adjusted gross estate resulting from the deduction of the income tax deficiency, interest thereon to date of death and penalty."

§14.04 *Mortgages*

Indebtedness secured by a mortgage or lien is listed on part 2, if the full value of the property is included in the gross estate at its value undiminished by the amount of the mortgage or lien. Notes and other obligations secured by the deposit of collateral, such as stocks and bonds, should also be listed on Part 2. Instructions, p. 18.

[A] Amount deductible

Where the debt is enforceable against other property of the estate not subject to the mortgage or lien, or if the decedent was personally liable; the full value of the property is included in the estate and the full amount of the debt is listed on Schedule K. Instructions, p. 18. If the decedent's estate is not liable, such as would be the case with non-recourse debt, then only the equity in the property is reported and debt is not listed on this schedule. *Id.*

[B] Information reported

List the schedule and the item number where the property that is security is reported. Instructions, p. 18. Include the name and address of the mortgagee, payee, or obligee, and the date and terms of the mortgage, note, or other agreement by which the debt was established, the face amount, the unpaid balance, the rate of interest, and the date to which the interest was paid before the decedent's death. *Id.*

§14.05 *Medical expenses*

The instructions provide regarding medical expenses,

> Health nuts are going to feel stupid someday, lying in the hospitals dying of nothing.
>
> --Redd Foxx

> If you choose to deduct medical expenses of the decedent only on the estate tax return, they are fully deductible as claims against the estate. If, however, they are claimed on the decedent's final income tax return under section 213(c), they may not also be claimed on the estate tax return. In this case, you also may not deduct on the estate tax return any amounts that were not deductible on the income tax return because of the percentage limitations.
>
> Instructions, p.16.

The regulations under section 213(c) support this result. Treas. Reg. §1.213-1(d). This means that the threshold of 7 1/2% of AGI that cannot be deducted on the Form 1040 cannot be taken as a deduction on the Form 706. Rev.Rul. 77-357, 1977-2 CB 328.

§14.06 *Attachments*

The instructions do not list any attachments required for this schedule. Voluntary attachment of promissory notes or mortgages invites IRS scrutiny of the validity of the debt, yet it may still be attached if necessary to make adequate disclosure to the IRS.

§14.07 *Audit*

The instructions state, "Keep all vouchers and original records for inspection by the Internal Revenue Service." Instructions, p. 18.

15 SCHEDULE L - NET LOSSES DURING ADMINISTRATION AND EXPENSES INCURRED IN ADMINISTERING PROPERTY NOT SUBJECT TO CLAIMS

§15.01 *Net losses during administration*

Losses from theft, fires, storms, shipwrecks, or other casualties that occurred during administration of the estate are deductible on Schedule L. To be deductible, the loss must occur during administration of the estate and the property must not have been distributed before the loss occurs. Treas. Reg. §20.2054-1. Presumably, the method of calculating the loss will be the fair market value of the item before the loss less the fair market value of the item after the loss.

[A] Economic losses

While the regulations and the instructions appear to deal with physical losses only, purely economic losses due to a catastrophic event might also be deductible, although there is nothing in the regulations or the cases to date that addresses purely economic losses. Take the estate of a decedent who died on or before March 10, 2001. September 11, 2001, was beyond the alternate valuation date. If the estate contained a closely held business interest involved in the travel industry and the value of the assets were decreased sharply by the events of 9-11, then the loss was merely economic due to the catastrophic event. It would seem to your author that the loss must be permanent and not simply an economic downturn that may return in future years. Short of bankruptcy, it may be impossible to claim the deduction or a purely economic loss due to a catastrophic event, because a deductible physical loss under IRC § 2054 is a permanent loss. Also, the deduction should not be seen as frustrating public policy. In TAM 9207044 the IRS took the position that a decedent's estate was not entitled to deduct as a loss the value of cash and the fair market value of marijuana that was forfeited under applicable Florida drug enforcement laws because such deduction would have frustrated a sharply defined state and federal public policy against drug trafficking.

Also, see the discussion on catastrophic economic events at the subsections "Catastrophic events discounts," in Chapter 4, "Schedule A, Real Estate," and in Chapter 5, "Schedule B, Stocks and Bonds."

[B] Insurance

The amount deductible is reduced by the amount reimbursed by insurance or otherwise. The amount of insurance or other compensation for loss must be stated.

[C] Information required

The instructions require that the loss sustained and the cause be described in detail. The schedule and the item numbers for the property must be identified. Instructions, p. 18.

[D] Alternate value

If alternate value is claimed, the amount by which the item was reduced cannot be deducted. Instructions. p. 18.

[E] Deductions not permitted

Losses claimed as a deduction on the federal income tax return may not be deducted on Schedule L. Depreciation in the value of the securities or other property is not deductible. Instructions, p. 18.

§15.02 *Expenses incurred in administering property not subject to claims*

[A] Deductible expenses

The expenses deductible on Schedule L are expenses incurred in the administration of a trust established by the decedent prior to death or transfer or clearance of title to other non-probate property included in the federal gross estate. Instructions p. 18. These expenses are basically those that would be deductible if the property was included in the probate estate, Treas. Reg. §20.2053-8(b), and deductible on Schedule J. Examples would be expenses incurred in administering a revocable trust established by the decedent or winding down a section 2044 property trust of which the decedent was the trustee. The requirement is that the property be included in the gross estate and the deduction would not be available for a trust, the assets of which are not included in the gross estate.

IRC § 2053(b) provides,

> [T]here shall be deducted in determining the taxable estate amounts representing expenses incurred in administering property not subject to claims which is included in the gross estate to the same extent such amounts would be allowable as a deduction under subsection (a) if such property were subject to claims, and such amounts are paid before the expiration of the period of limitation for assessment provided in section 6501.

The regulations elaborate on this limitation:

> The only expenses in administering property not subject to claims which are allowed as deductions are those occasioned by the decedent's death and incurred in settling the decedent's interest in property or vesting good title to the property in the beneficiaries. Expenses not coming within the description in the preceding sentence but incurred on behalf of the transferees are not deductible.
>
> Treas. Reg. §20.2053-8(b).

The distinctions between what is deductible and what is not deductible can be fine. In *Central Trust Company of Cincinnati v. Welch*, 304 F.2d 923 (6th Cir 1962), trustee's fees for extraordinary services incurred and paid in connection with the successful defense of litigation attacking the validity of a trust created by decedent during her lifetime was deductible as an expense incurred in administering property includible in the gross estate but not subject to claims. But the legal expenses incurred by a trust beneficiary and paid by the estate were not deductible, in *Estate of Heckscher*, 63 TC 485 (1975), because it was found that the declaratory judgment action involved the protection of the beneficiary's own interest in the trust and were not incurred in winding up the decedent's affairs. The

Tax Court looked to the regulations, Treas. Reg. §20.2053-3(c)(3), which state,

> Attorney's fees incurred by beneficiaries incident to litigation as to their respective interest do not constitute a proper deduction, inasmuch as expenses of this character are incurred on behalf of the beneficiaries personally and are not administration expenses.

The Tax Court's conclusion appears to rest on the failure of the estate to prove why the expenses should be deductible.

> The record in this case does not reveal why [the beneficiary] employed her own attorney to participate in the action brought by the trustee for instructions or why her attorney's services were necessary or for the benefit of the trust or the estate . . . We assume the attorneys fees were incurred for the protection of [the beneficiary]'s own interest We conclude that there were not "incurred in winding up the affairs of the deceased" . . .

Id. at 501.

Had the estate offered proof as to the benefit the estate received from the beneficiary's attorney, or had the preparer addressed that issue when the return was prepared or better still, when the declaratory judgment action was being contemplated, the deduction may have been approved.

The limitation that the amounts be paid before the expiration of the period of limitation for assessment (generally three years after the due date of the return) only applies to expenses for property not subject to claims.

[B] Information required

The instructions require the name and address of the person to whom the expense is payable and the nature of the expense. The schedule and item number of the property for which the expense is incurred must be identified. Instructions, p. 18.

[C] Estimated expenses

If the exact amount of the expense is not known, an estimate may be deducted, provided that the amount may be verified with reasonable certainty and will be paid before the period of limitations for assessment expires. Instructions, p.18.

§15.03 *Audit*

The instructions state, "Keep all vouchers and receipts for inspection by the Internal Revenue Service." Instructions p. 18.

16 SCHEDULE M - MARITAL DEDUCTIONS

§16.01 *Qualification for the marital deduction*

[A] Citizenship

The decedent must be a citizen or resident of the United States. The marital deduction is generally not allowed if the surviving spouse is not a U.S. citizen. The marital deduction is allowed for property passing to a non-citizen spouse in a "qualified domestic trust" (QDOT) or if such property is transferred or irrevocably assigned to such a trust before the estate tax return is filed. Also, if the spouse becomes a U.S. citizen before the return is due, the deduction will be allowed. Form, p. 28. Good practice suggests that the preparer early on confirm the citizenship of the surviving spouse, so there is adequate time to meet the QDOT requirements.

Tasteful and discreet inquiry can be made by asking the surviving spouse, early in the preparation of the return, these questions set forth at the beginning of Schedule M, which must be answered to complete the return.

2a. In what country was the surviving spouse born? _____

b. What is the surviving spouse's date of birth? _____

c. Is the surviving spouse a U.S. citizen? [Yes or No] _____

d. If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship? _____

e. If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen? _____

The instructions do not elaborate on these questions.

[B] Spouse

The decedent must be survived by a *spouse.*

[1] Texas law

The decedent and the significant other (if of the opposite sex) may be married by ceremony, TEX. FAM. CODE § 2.001 *et seq*., by written declaration, TEX. FAM. CODE § 2.401(a)(1), or by common law, TEX. FAM. CODE, §2.401(a)(2). A substantial gift to a spouse is less expensive than the same gift to a mere friend. Texas law does not recognize same sex marriage as valid. TEX. FAM. CODE §1.01 (Vernon's 1993). A ceremonial marriage between a man and a

transsexual born as a man, but surgically and chemically altered to have the physical characteristics of a woman, was held not valid in *Littleton v. Prange*, 9 S.W.3d 223, 225-226 (Tex. App.--San Antonio 1999). This Texas case remains the leading case in the United States on this question.

[2] Federal law

In determining the meaning of any Act of Congress, any ruling, regulation, or interpretation of the United States administrative bureaus and agencies, the word "marriage" means only a legal union between one man and one woman as husband and wife, while the word "spouse" refers only to a person of the opposite sex who is a husband or a wife. Defense of Marriage Act, Pub. L. 104-199, 1/0 Stat. 2419 (1996) Sec. 3, 1 U.S.C. §7. Thus, neither a same sex marriage under Massachusetts law, nor a civil union under Vermont state law will be recognized by the Internal Revenue Service as creating a spouse for federal estate tax marital deduction purposes.

[C] Survival of spouse

The decedent must be *survived* by a spouse. If state law, the will, or an instrument of transfer, provides a survivorship requirement, then the spouse must meet that survivorship requirement. For example, a bequest by will of all of the residuary to the surviving spouse if the spouse survives by 6 months means that the spouse must survive by at least 6 months for the gift to qualify for the marital deduction. It is possible that neither spouse survives the other.

[1] State survivorship law

Section 47 of the TEXAS PROBATE CODE provides that a person who fails to survive the decedent by 120 hours is deemed to have predeceased the decedent unless the decedent's will provides otherwise. TEX. PROB. CODE 47 (Vernon's 1993). The applicable state survival law must be met to the extent not overruled by the testamentary instrument.

[2] Six months maximum

If a period of survival is required, the period cannot exceed six (6) months or for any period that could exceed six (6) months after the decedent's death, or the transfer will not qualify for the marital deduction. IRC § 2056(b)(3)(A). For example, a will requirement that the spouse must survive the period of administration does not qualify for the marital deduction because the period of administration may exceed six (6) months.

[3] Simultaneous death

The regulations contain special requirements where the order of death of the spouses cannot be determined, and there is no presumption provided by local law or the will.

> If the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, the decedent's will, or otherwise) that the decedent was survived by his spouse will be recognized as satisfying paragraph (b)(1) of Section 20.2056(a)-1, but only to the extent that it has the effect of giving to the spouse an interest in property includable in her gross estate under part III of subchapter A of chapter 11. Under these circumstances, if an estate tax return is required to be filed for the estate of the decedent's spouse, the marital deduction will not be allowed in the final audit of the estate tax return of the decedent's estate with respect to any property interest which has not been finally determined to be includable in the gross estate of his spouse. Treas. Reg. §20.2056(c)-2(e).

[D] Receipt of property by spouse

The property must pass *from the decedent* to the surviving spouse in some manner. The property may pass by bequest or devise, by operation of law (survivorship or intestacy), by being the appointee of the decedent's exercise of a power of appointment or in default of a non-exercise of a power of appointment, by being a beneficiary of insurance proceeds, by transfer of property during decedent's lifetime that is includable in decedent's estate, by a survivor interest in an annuity, by disclaimer of an interest by another person resulting in the disclaimed property passing to the surviving spouse, and by the surviving spouse's exercise of any of his or her rights to receive property under the Texas Probate Code. The value of any property that does not pass from the decedent to the surviving spouse may not be deducted on Schedule M. In *U.S. v. Stapf*, 375 U.S. 118 (1963), the Supreme Court held that the marital deduction was limited to the net economic benefit received by the surviving spouse.

[E] Terminable interest rule

An interest passing to the surviving spouse will not be deductible if, due to lapse of time, occurrence of an event, or the failure of an event to occur, the interest of the spouse will terminate and pass to another person. IRC § 2056(b); Form, p. 28. For example, if the use and benefit of the property terminates upon the remarriage of the spouse, then the interest is terminable and does not qualify for the marital deduction. Below is an important exception for qualified terminal interest property (QTIP) trust.

[1] Examples of terminable interests

A testamentary trust that distributes all income to the spouse for 20 years (or until the spouse's earlier death), when the trust terminates and is distributed to her children, is a non-deductible terminable interest. A trust providing for distributions to the spouse, unless the spouse remarries, in which event all future trust distributions are to the children, is a non-deductible terminable interest. A will directing the executor to purchase an annuity making fixed payments for the spouse for life is a non-deductible terminable interest. A patent is also a non-deductible terminal interest.

[a] Texas homestead

The rights of the surviving spouse to the homestead are not deductible on Schedule M because the homestead right is a non-deductible terminable interest. The surviving spouse's rights will terminate upon abandonment.

[2] Examples of interests not terminable

[a] In terrorem clause

An in terrorem or no contest clause conditioning the bequest on the spouse not bringing an action to contest the will does not create a disqualifying terminable interest. *See*, TAM 8735003; Rev. Rul. 82-184, 1982-2 CB 215; *Estate of Tompkins v. Comm*., 68 TC 912 (1977), *acq*., 1982-1 CB 1.

[b] Annuity

If decedent, during life, purchased a joint and survivor annuity calling for payments to himself and to his wife who survived him, the value of the survivor's annuity, to the extent that it is included in the gross estate, qualifies for the marital deduction. Even though the interest will terminate on the wife's death, no one else will possess or enjoy any part of the property. Form, p. 28. (Compare this to where the executor is directed to purchase an annuity.)

[c] Trusts

A trust providing that all income will be paid to the child for ten (10) years and then terminating with distributions to the spouse or the surviving spouse's estate, qualifies for the marital deduction to the extent of the value of the remainder interest; no interest in the remainder passes to another person, and the interest of the spouse does not terminate.

[d] Bonds, notes and contracts

"The ownership of a bond, note or other contractual obligation, which when discharged *would not have the effect of* an annuity for life or for a term, is not considered a terminable interest." (Emphasis added.) Form, p. 28.

[e] Family allowance

Family allowance payments to the surviving spouse, TEX. PROB. CODE §286, should qualify for the marital deduction.

[3] Allocation of income

If any of the income from a trust can be allocated to anyone other than the surviving spouse, the property interest of the surviving spouse will be considered terminable and the property will not qualify for a marital deduction.

[4] Restrictions on sale

LTR 9606008 (11/9/95) held that a gift was not a terminable interest. Wife proposed to transfer corporate stock to her husband and claim the marital deduction. The stock is subject to a right of first refusal under which the corporation can meet any offer of a third person. In addition, both the corporation and the wife have an option to purchase the stock at fair market value if the parties divorce or if the husband dies. The IRS held that the gift qualifies for the marital deduction since the husband will receive fair market value of the stock in any case.

[F] Allocating expenses to income

[1] Estate of *Hubert*

The *Estate of Hubert v. Comm*., 63 F.3d 1083 (11th Cir. 1995) involved both marital and charitable deductions. The decedent's will permitted the executor to allocate administration expenses between income and principal. The executors allocated some expenses to principal and the balance were allocated to income and deducted on the estate's income tax returns. The Service contended that the marital and charitable deductions should be reduced by all of the administration expenses, not just those charged to principal. The Tax Court held for the taxpayer in 101 TC 314 (1993). The Eleventh Court of Appeals affirmed the Tax Court for the taxpayer, adopting the opinion of the Tax Court as its own and holding that the marital and charitable deductions are not to be reduced by expenses allocated to income where the will permits allocation of expenses to income. This decision was in conflict with the decisions of two other circuits, *Estate of Street v. Comm*., 974 F.2d 723 (6th Cir. 1992), and

Estate of Burke v. U.S., 994 F.2d 1576 (Fed. Cir.), holding to the contrary that the expenses reduced the deductions, whether allocated to principal or income. The Supreme Court granted certiorari in *Hubert*. In *Comm. v. Hubert*, 520 U.S. 93, 104-105 (1997), four justices with three concurring, held that the estate was not required to reduce its marital and charitable deductions by the amount of administration expenses paid from income generated by assets allocated to marital and charitable bequests, notwithstanding Service's contention that dollar-for-dollar reduction was required, where the Tax Court concluded that the discretion granted under the decedent's will to pay expenses out of income was not a material limitation on the right of the surviving spouse and charitable beneficiary to receive income, and the Service did not challenge the estate's determination of expected future administration expenses as of the date-of-death in calculating deduction amounts.

For a case in which a district court applied the holdings of *Hubert* to permit the deduction of accounting fees and mediation expenses along with interest payments on a gift tax deficiency as charges against marital bequest income and not requiring a reduction in the marital deduction, see *Brown v. U.S.*, 88 AFTR2d Par. 2001-5500. The court also found that certain estate tax deductions would require a reduction in the marital deduction. The decedent died in 1993 before the effective date of the regulations discussed below.

[2] IRS regulations

The IRS has adopted amendments to Treas. Reg. § 20.2056(b)-4 relating to the effect of certain administration expenses on the valuation of property that qualified for the estate tax marital deduction. The final regulations are effective for estates of decedents dying on or after December 3, 1999. The regulations do not seek to define a material limitation, but rather bifurcate estate expenses into estate transmission expenses and estate management expenses.

[a] Estate management expenses

Management expenses, which do not reduce the value of property for marital deduction purposes, are expenses that would be incurred in investing, maintaining, and preserving the estate property. The marital deduction is not reduced by estate management expenses attributable to and paid from the marital share unless those expenses are deducted on the estate tax return under IRC § 2053.

[b] Estate transmission expenses

Estate transmission expenses, which are those expenses that would not have been incurred but for the decedent's death, reduce the value of the property for marital deduction purposes and must be deducted on the estate tax return. Estate transmission expenses include any administration expense that is not an estate management expense. Examples include probate fees, expenses incurred in construction proceedings and defending against will contests and appraisal fees, as well as most executor's commissions and attorney's fees.

[c] Unrelated estate management expenses

The marital deduction is reduced by the amount of any estate management expenses paid from the marital share but attributable to a property interest not included in the marital share. Treas. Reg. §20.2056(b)-4(d)(1)(iii)(4).

[d] Estate management expenses deducted on Form 706

The marital deduction must be reduced by the amount of any estate management expenses deducted under IRC § 2053 on the Form 706. Treas. Reg. §20.2056(b)-4(d)(3). This is based upon the Service's reading of IRC § 2056(b)(9) which provides that nothing in IRC § 2056 or the other estate tax provisions permits deduction for the Form 706 more than once with respect to the same decedent. This is bolstered in the regulations by an example. Treas. Reg. §20.2056(b)-4(d)(5).

> Example 4: The decedent, who dies in 2000, has a gross estate of $3,000,000. Included in the gross estate are proceeds of $150,000 from a policy insuring the decedent's life and payable to the decedent's child as beneficiary. The applicable credit amount against the tax was fully consumed by the decedent's lifetime gifts. Applicable State law requires the child to pay any estate taxes attributable to the life insurance policy. Pursuant to the decedent's will, the rest of the decedent's estate passes outright to the surviving spouse. During the period of administration, the estate incurs estate management expenses of $150,000 in connection with the property passing to the spouse. The value of the property passing to the spouse is $2,850,000 ($3,000,000 less the insurance proceeds of $150,000 passing to the child.) For purposes of determining the marital deduction, if the management expenses are deducted on the estate's income tax return, the marital deduction is $2,850,000 ($3,000,000 less $150,000) and there is a resulting taxable estate of $150,000 ($3,000,000 less a marital deduction of $2,850,000). Suppose, instead, the management expenses of $150,000 are deducted on the estate's estate tax return under section 2053 as expenses of administration. In such a situation, claiming a marital deduction of $2,850,000 would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056 and would shield from the estate taxes

the $150,000 in insurance proceeds passing to the decedent's child. Therefore, in accordance with section 2056(b)(9), the marital deduction is limited to $2,700,000, and the resulting taxable estate is $150,000.

[G] Reduction for taxes paid

The marital deduction is reduced to the extent that taxes or other non-deductible expenses are paid from the property otherwise qualifying for the marital deduction. IRC § 2056(b)(4), making the marital deduction available only for the net value of qualifying property interests that pass to the surviving spouse. Treas. Reg.§ 20.2056 (b)-4. See *Estate of Robert H. Lurie v. Comm.*, TC Memo 2004-19 for application of this rule to a revocable trust.

The express terms of a tax payment clause may control and reduce a maximum marital deduction. In *Estate of Lewis v. Comm.*, TC Memo 1995-168, the decedent's wills and codicils, after specific devises to her children, left the residue in a marital trust for her husband. The tax clause in the will directed that all taxes be paid from the residue. The value of the non-marital gifts exceeded the unified credit amount. Even though the will clearly evidenced the intent of the testatrix to maximize the marital deduction, the express terms of the tax payment clause controlled.

The marital deduction available with respect to a residuary bequest by a decedent to her surviving spouse was reduced by a proportionate share of the estate taxes owed by the estate because the decedent's will dictated that all estate taxes be paid out of the property in the residuary estate. This directive ran contrary to the Texas apportionment statute, which assigns to each person interested in an estate the portion of estate taxes resulting from his or her interests. *Estate of Miller v. Comm.*, 85 AFTR2d 200-1047 (5th Cir. 2000). The author wonders if this could have been handled by the beneficiaries other than the spouse disclaiming the benefits of the will's tax allocation clause.

[H] Unlimited marital deduction

The marital deduction is unlimited, except for wills containing an unlimited marital deduction clause executed before September 12, 1981, in which case the marital deduction is limited to 50 percent of the adjusted gross estate. *Estate of Amiel v. Comm.*, 74 TCM (CCH) 239 (1997), is a relatively recent example of a case imposing the limits of prior law.

[1] "Adjusted gross estate"

Watch for formulas that use the now obsolete term "adjusted gross estate." The term "adjusted gross estate" is now defined in IRC § 6166(b)(6), but the limits of prior marital deduction law may be imposed by the IRS, including the 50% limit as well as disqualifying for the marital deduction the decedent's share of the community property. Look for any intent expressed in the will to adopt tax law in affect at death. See TAM 9048001.

[2] Adjusted taxable gifts

Make sure the formula takes into account adjusted taxable gifts or the marital deduction may not be sufficient to result in zero tax. See PLR 8722010.

§16.02 *Property interests not deductible on Schedule M*

[A] Not passing from decedent

Any property that does not pass from the decedent to the surviving spouse cannot be listed on Schedule M. Form, p. 28. Property passing to the surviving spouse that cannot be related to a will provision or provision of a non-testamentary transfer document does not pass from the decedent.

For example, if the decedent's will left all of his property to his children, requesting them to treat the surviving wife "fairly," and the children ask the executor to transfer $100,000 to the surviving wife, that interest to the wife does not pass from the decedent.

[1] Will contest settlements

Obviously what the surviving spouse gives up in a will contest will not be subject to the marital deduction. Treas. Reg. §20.2056(c)-(2)(d)(1). The trick is to qualify for the marital deduction what the surviving spouse receives from a will contest settlement. The IRS will look for a true controversy.

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse. Treas. Reg. §20.2056(e)-2(d)(2).

The regulation permits a marital deduction for property interests surrendered or assigned to the

surviving spouse as a result of controversy, but the controversy requirement does not require the presence of actual litigation between the parties. In *Bel v. U.S.,* 452 F.2d 683 (5th Cir. 1971), the court stated,

> We have held that the parties' adverse interests in the decedent's estate and a resulting settlement achieved at the conclusion of arm's length negotiations are sufficient to evidence the existence of a "controversy" within the meaning of the above regulation. In Citizens & Southern we stated that the "will controversy" regulation does not "encompass only those settlements achieved at the end of an armageddon," but by the same token, we think that for purposes of the regulation, there must be at least a skirmish between the settling parties. 452 F. 2d at 694.

The same conclusion was reached in *Estate v. Barrett v. Comm.*, 22 TC 606 (1954) 22 TC 606 (1954). This apparently represents the position of the National Office, as it was stated in TAM 9347003,

> Accordingly a settlement of a claim asserted by the surviving spouse for a share of the decedent's estate must be based on a legally enforceable claim and paid pursuant to a bona fide compromise agreement. The claim must be asserted in good faith and settled in arm's length negotiations and may be arrived at without court action.

It certainly is in accord with the Service's position as stated in Rev. Rul. 66-139, 1966-1 CB 225, where the Service ruled that a valid claim by the surviving spouse to a share in the decedent's estate, made in good faith and settled as a result of arm's length negotiations without any court contest, will qualify as a bona fide claim within the meaning of the regulations. The ruling says that where such claim is paid by the decedent's estate, the payment will qualify for the marital deduction to the extent that the interest that would have passed to the surviving spouse as a result of the completed exercise of the spouse's right (i.e., in a court contest) would have been a deductible interest. As for the lack of a controversy as the predicate upon which the settlement occurs will disqualify the claimed marital deduction, an example is found in *Estate of Allen v. Comm.,* 60 TAM (CCH) 904 (1990).

Further the regulation requires that the surviving spouse prior to settlement possess "enforceable rights" in the decedent's estate, and determining the existence of enforceable rights will be a question of state law that depends up on the property interests held and transferred by the decedent. *Estate of Brandon v. Comm.*, 828 F.2d 493 (8th Cir. 1987). Yet, as a result of *Comm v. Bosch*, 378 US 456 (1967) the federal courts in tax matters may not be bound by a lower state court's determination of property interests where the lower court fails to apply the law of the highest court of the state. Under *Ahmanson Foundation v. United States*, 674 F. 2d 761 (9th Cir. 1981), the federal courts need not honor the parties characterization of property rights under a settlement agreement.

In *Ahmanson Foundation*, the circuit court held that property distributed to a spouse pursuant to a compromise settlement will be treated as passing from the decedent for marital deduction purposes, only if the distribution represents a good faith settlement of an enforceable claim. "[E]ither a good faith settlement or a judgment of a lower state court must be based on an enforceable right under state law properly interpreted, in order to qualify as 'passing' pursuant to the estate tax marital deduction." *Id.* at 674, citing *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Hence the federal courts will make an independent determination of the presence of enforceable rights in the surviving spouse. *Estate of Brandon v. Comm.*, 828 F. 2d493 (8th Cir. 1987).

Estate of Huber v. Comm., 101 TC 314 (1993) (state court's findings do not govern federal court's determination regarding validity and enforceability of spouse's claims under state law; settlement distributions qualified for marital deduction because they reflected what the surviving spouse could recover from pursuing rights under state law to challenge decedent's will and codicil; *Estate of Depaoli v. Comm,*. 66 TCM (CCH) 1493 (1993) (no marital deduction for settlement distribution compromising inheritance rights not recognized under applicable state law).

While the enforceable rights surrendered or released need to be the same type of property interest as the property interested received, both the property interest surrendered or released and the property interest received by the surviving spouse must be a property interest that qualified for the marital deduction. In *Estate of Carpenter v. Comm.* 67 TCM (CCM) 2400 (1994), the spouse's rights under the will consisted of terminal interests in a trust that would not qualify for the marital deduction because the settlement agreement could not transform a nondeductible interest into a qualified interest. To the same effect is TAM 8236004. The settlement must be in the form that qualifies for the marital deduction. *United States Trust Co. of NewYork v. Comm.*, 321 F. 2d 908 (2d Cir. 1963) (life estate with general power of appointment converted into life estate) ; *Estate of Tebb v. Comm.*, 27 TC 671 (1957) (fee simple converted into life estate). Several Rulings held that the settlement distribution need not be the same property right as the original property as the original property right released where both qualify under IRC § 2056 *Rev*

Rul.83-107, 1983-2 CB 159 (cash payment received, commutable dower interest surrendered); TAM 9251002 (trust interest received, elective statutory share released); TAM 9246002 (cash payment received, commutable life estate in real property released).

[2] Settlement through disclaimers

While Texas law favors family settlement agreements, in the author's experience, the marital deduction is more certain where accomplished by disclaimers rather than a settlement agreement alone. Qualified disclaimers are discussed below.

In *Davies v. U.S.*, 124 F. Supp. 2d 717 (D. Maine 2000), the decedent's will created an annuity, not qualified for the marital deduction, for his wife for life with the remainder to his children. The spouse filed for her elective share and eventually settled with the estate for a lump sum payment in lieu of the annuity. The estate amended its estate tax return claiming a marital deduction. The IRS denied the marital deduction as did the district court on summary judgment. The annuity itself would not have been entitled to a marital deduction, and although normally an elective share is entitled to a marital deduction, under applicable state law the elective share was offset by the amount of the annuity. Effectively the court disallowed the transmutation of a nondeductible interest into a deductible one. This case, in the author's view, shows the importance of completing litigation before the return is filed and not relying on obtaining the marital deduction on an amendment. To the author, it would seem that the spouse could have disclaimed the annuity and received the elective share without the limits of the annuity terms.

Disclaimers were effectively used in *Estate of Lassiter v. Comm.*, TC Memo 2000-324, to "reform" a testamentary trust to qualify for the marital deduction. The residuary estate passed to a testamentary trust in which principal and income were for the benefit of the surviving spouse and decedent's descendants. The surviving spouse held inter vivos and testamentary special powers of appointment in favor of the decedent's descendants. The descendants disclaimed any right to receive distributions from the trust during the surviving spouse's life. A guardian ad litem disclaimed on behalf of minor or unborn descendants to receive distributions during the spouse's life. The spouse disclaimed any right to appoint trust property during her life and any right to require the trustee to accumulate trust income during her lifetime. As trustee, the spouse disclaimed the power to distribute trust property to descendants during her life. The disclaimers, all effective under state law and IRC § 2518 were qualified and the trust qualified for the marital deduction because the spouse was entitled to all income from the property payable annually and no person had a power to appoint trust property to any person other than the surviving spouse. A plan of disclaimers in many instances can make an otherwise unqualified transfer qualify for the marital deduction.

[3] Taking against the will

If the surviving spouse elects to take against the will (forced share not available in Texas) the property interests offered by the will are not considered to have passed from the decedent to the surviving spouse, and the marital deduction is to be based on the interests the surviving spouse receives pursuant to the election. Treas. Reg. §20.2056(c)-2(c).

This rule as applied in *Davies v. U.S.*, 87 AFTR 2d ¶2001-417 (D.C. Me. 2001), to reduce the amount of the marital deduction for the settlement by the amount the spouse received for surrender of a non-qualified interest. The decedent left a trust that provided for monthly payments of $3,333.00 per month until his surviving wife reached age 65 and $2,500.00 per month thereafter for life. The wife filed a petition to force her elective share pursuant to Maine law. The augmented estate was found to be $2,121,931 and the value of the elective share was $707,310. The estate claimed a marital deduction of $697,490. In a settlement agreement, the widow received a lump some of $260,000 in lieu of the annuity which she surrendered plus a "settlement inducement amount" of $37,400. The IRS contended that neither the lump sum of $260,000, the present day value of the annuity, nor the inducement of $37,400 were deductible and the estate conceded the $37,400 as not deductible. Under Maine law, the elective share to which the widow was entitled was reduced by the value of the annuity interest. The IRS contended and the court held that the settlement received for relinquishment of the non-deductible annuity was not deductible, because it did not "pass" from the decedent as required by the regulation quoted above. The court's holding is brought into question on policy grounds when it cites *Bosch*, 387 U.S. 464 (1967) as

> "noting Congress' definite concern with the elimination of loopholes and escape hatches that might jeopardize the federal revenue as evidence by limitations on allowance of the marital deduction set forth in Sections 2056(b), (c) and (d)."

Bosch was decided before the unlimited marital deduction became law in 1982 under ERTA.

[4] Reformation

Reformation of a trust to qualify for the marital deduction where the trust failed to require payment

of all income to the spouse, was unsuccessful in *Ropp v. Comm.*, 140 F.3d 1211 (9th Cir. 1998). The order modifying the trust to give the spouse all of the income was not a construction order and there was no evidence that the decedent intended the trust to qualify for the marital deduction. The appeals court concluded that the order was not binding on the IRS. On the other hand, in *Kraus v. Comm.*, 875 F.2d 597 (7th Cir. 1989), *aff'g in part and rev'g and remanding in part*, TC Memo. 1998-154, the evidence was that the decedent intended the trust to qualify for the marital deduction, but the trust lacked the required general power of appointment. By mistake the draftsperson included a limited power of appointment and the local court reformed the trust instrument to restore the deleted general power. After offering evidence that a mistake had been made, the marital deduction was permitted.

In *Estate of Whiting v. Comm.*, TC Memo 204-68, a surviving spouse's interest in a "marital deduction trust" qualified for the marital deduction and the spouse was held to receive a qualifying income interest for life under IRC § 2056(b)(7), despite a trust provision providing for accumulation of income during disability of the spouse. Under Arkansas law, the conflict between the disability accrual provision and the all income distribution provision was resolved in favor of the decedent's manifest intent in the trust agreement to qualify for the marital deduction. The spouse's income distribution right was framed in mandatory and non-discretionary language and the disability accrual provision was seen in conflict, requiring a construction of the instrument. This case should be reviewed to see what must be proven to "reform" a non-qualifying interest.

[B] Not included in gross estate

To qualify for a marital deduction, the property must have been included in the decedent's gross estate and be listed on Schedules A through I. Property interests not included in the decedent's gross estate may not be deducted on Schedule M. Form, p. 28.

[C] Property otherwise deductible

Property deductible under another provision of the Internal Revenue Code will not qualify for the marital deduction. Form, p. 28. For example, compensation paid to the spouse for serving as the personal representative is deductible on Schedule J but not on Schedule M, but compensation paid on Schedule J will be income to the surviving spouse, whereas only IRD deducted on Schedule M will be subject to income tax. Property deductible on Schedule M must be reduced by any deductions claimed on another schedule with respect to the same property. Form, p. 28.

[D] Mortgaged property

The full value of a property interest that passes to the surviving spouse subject to a mortgage, other encumbrance, or an obligation of the surviving spouse, may not be deducted on Schedule M. Schedule M should include only the net value of the interest after reducing it by the amount of the mortgage, encumbrance or other obligation. Form, Schedule M, p. 28.

[E] Property disclaimed by spouse

The instructions state that Schedule M cannot include "[a]ny property interest disclaimed by the surviving spouse." Form, p.28. That is not an accurate statement of the rules regarding disclaimed property. The spouse could disclaim property and have it pass to the surviving spouse in a form that qualifies for the marital deduction. The disqualification for the marital deduction is not that it was "disclaimed by the surviving spouse," but rather that the property does not pass to the surviving spouse as a result of the disclaimer.

[1] Disclaimer of the Texas homestead

Because the surviving spouse's homestead rights do not qualify for the marital deduction, when the homestead is community property, consider proposing that the surviving spouse disclaim the decedent's half and retain only the spouse's half of the homestead. As a co-tenant, the survivor can occupy the entire residence. The survivor will be responsible for all upkeep and property taxes.

[2] Disclaimer of life insurance on survivor

Say that a couple owns as community property a life insurance policy on the life of Husband. If Wife dies first, her estate will include one-half of the value of the policy valued at its interpolated terminal reserve value, not the face amount of the policy. If the non-insured Wife's interest passes to the insured Husband, then upon the death of the insured Husband, all of the proceeds will be included in the insured Husband's estate. If the insured Husband disclaims the non-insured Wife's interest, then, upon the death of the insured Husband, insured Husband's estate will include only one-half of the proceeds.

[3] Preserve a minority interest

If a couple own an interest in property or community property, and the interest of the first to die passes to the survivor, then the surviving spouse's estate will not qualify for a minority discount on that item. By disclaiming the interest of the deceased spouse in that item, the surviving spouse preserves the minority discount.

§16.03 *Types of marital deductions*

[A] Outright transfers

An outright (fee simple) transfer to the surviving spouse will qualify for the marital deduction.

[B] Marital deduction power of appointment trust

If the spouse is entitled to all of the income for life, payable at least annually, with the spouse having a testamentary general power of appointment, the trust qualifies for the marital deduction, IRC § 2056(b)(5). The trustee may not have the power to accumulate income, but the regulations provide that the trust will qualify if the spouse has the power to require the distribution of all income annually. Treas. Reg. §20.2056(b)-5(f)(8). Generally, the trustee cannot be authorized to invest in non income producing property, although it can be permitted if the surviving spouse has an unlimited power to require the trustee to make the trust reasonably income producing. Treas. Reg. §20.2056(b)- 5(f)(4) & (5). The trust need not be reasonably income producing to the extent it includes a personal residence or property held for the use of the surviving spouse for life. The power of appointment must include the power to appoint to the power holder (the spouse) or the estate of the power holder (the estate of the spouse). Any power granted to the trustee or any other person to appoint the property during the life of the spouse will disqualify the trust. IRC § 2056(b)(5), Treas. Reg. §20.2056(b)-5(g).

[C] The estate trust

An estate trust is for the exclusive benefit of the surviving spouse with distribution at the discretion of the trustee. The estate trust can provide for accumulation of income and the property need not be reasonably income producing. Rev. Rul. 68-554, 1968 - 2 CB 412. At the death of the spouse, the entire trust, including all accumulated income, must be distributed to the estate of the surviving spouse. Treas. Reg. §20.2056(c)-2(b)(iii).

[D] QTIPs

These are discussed in the next section.

[E] QDOTs

These are discussed below.

§16.04 *Qualified terminable interest property (QTIP) trusts*

If the surviving spouse has a qualifying income interest for life and the QTIP election is made, the property qualifies for the marital deduction. IRC § 2056(b)(7).

[A] Qualifying income interest

A qualifying income interest is an interest where the spouse is entitled to all the income payable at least annually and no person has any power to appoint any part of the property to any person other than the surviving spouse.

It has been held that where the income interest given by the decedent to his surviving spouse was limited to the amount of income property for her "health, education, or support, maintenance, comfort and welfare" in accordance with her "accustomed manner of living" the income interest does not give the surviving spouse virtual ownership of the trust income that is required to make the trust eligible for the marital deduction as required for qualified terminable interest property. *Davis v. Comm.* 9th Cir. No. 03-72240. The same result was reached in *C. Aronson Estate*, TC ¶ 45,189(M) were decedent's will failed to qualify for QTIP treatment when it provided that his wife was to receive only as much income from the trust as she "needed" during her lifetime.

[1] Underproductive Property

A corollary of the requirement that the surviving spouse receive all of the income is the requirement that the terms of the trust and the surrounding circumstances considered as a whole not evidence an intention to deprive the spouse of the requisite degree of enjoyment of the income of the trust or use of the trust property. The regulations state that a trust power to retain trust assets that consist substantially of underproductive property will not disqualify the interest if the applicable rules for the administration of the trust require or permit the spouse to require that the trustee either make the property productive or convert it within a reasonable time. Treas. Reg. § 20.2056 (b) 5 (f) (4). For an example of the application of this requirement, see TAM 200339003.

[2] IRA's paid to trust

In Rev. Rul. 2000-2, 2000-1 CB 305, where an IRA holder designated the trustee of a testamentary trust as its beneficiary, the IRS ruled that the executor may elect QTIP treatment for the IRA and the trust under IRC § 2056(b)(7) because (i) the surviving spouse can compel withdrawal and distribution of the income from the IRA and (ii) no other person has a power to appoint any part of the trust property away from the survivor. Specific language of the ruling should be considered.

> Under the terms of the testamentary trust, [the surviving spouse] is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to [the surviving spouse]. If

> [the surviving spouse] exercises this power, the trustee must withdraw from the IRA the greater of the amount of income earned on the IRA assets during the year or the annual minimum required distribution. Nothing in the IRA instrument prohibits the trustee from withdrawing such amount from the IRA. If [the surviving spouse] does not exercise this power, the trustee must withdraw from the IRA only the annual minimum required distribution.

Preparers taking advantage of this ruling must examine both the testamentary trust instrument and the IRA agreement. Because a QTIP election must be made with respect to both the trust and the IRA itself, both the QTIP and the IRA should be listed separately on Schedule M.

[3] Annuity payments

Where the trust provides for an annuity payment to the surviving spouse, the deductible interest is the specific portion of the trust that would produce income equal to the annual annuity amount. Treas. Reg. §20.2056(b)-7(e)(2). Where the annuity amount is to be increased annually to account for inflation, any increases in the amount of the annuity payable to the surviving spouse will not be taken into account in valuing the deductible interest. *Estate of Sansone v. U.S*., 87 AFTR2d 2001-1361 (D.C. Ca. 2001); *affirmed unpub. opinion R. Sansone Est.*, 2002-2 USTC ¶60,442 (9th Cir. 2002) (limitation in. Treas. Reg. §2-/2-56)b-7(e)(2) with respect to inflation adjustments or other increases a reasonable interpretation of IRC § 2056(b)(7)).

[4] Termination upon incapacity

Provisions for terminating income distributions in the event of incapacity of the spouse may, depending on whether the incapacity provisions or the marital deduction qualification provision predominates, disqualify the trust for failure to provide an income interest for life. In *Estate of Whiting v. Comm*., TC Memo 2004-68 (2004), the IRS disallowed a marital deduction for a trust passed from the decedent and for which a QTIP election had been made, but for which it believed there was no qualifying income interest for life because of the disability provisions that purported to terminate income upon incapacity. The Tax Court held for the estate that the disability provision needed to give way to the decedent's intent to qualify for the marital deduction, applying trust interpretation rules of the applicable state, Arkansas. The Tax Court distinguished two cases cited by, and favorable to, the IRS, *Estate of Walsh v. Comm*., 110 TC 393 (1998) and *Estate of Tingley v. Comm*, 22 TC 402 (1954), *aff'd. sub nom. Starrett v.Comm*., 223 F.2d 163 (1st Cir. 1955).

[B] QTIP election

[1] How made

The QTIP election is made by listing the property on Schedule M and deducting its value. If the property is listed on Schedule M and its value deducted, it is presumed that the QTIP election is made. Form, Schedule M, p. 29. Prior versions of the return required that a proper box be checked; that is no longer a requirement. If the property is elected for the marital deduction then the property must be included in the surviving spouse's federal gross estate.

Estate of Cavenaugh v. Comm., 51 F.3d 597 (5th Cir. 1995), involved the surviving spouse's estate after the estate of the first-to-die took a maximum marital deduction under a QTIP election. The wife's will, who died in 1983, left her residuary estate in trust with income to her husband for life. Husband, as the executor of wife's estate, hired an accountant to prepare the estate tax return and instructed him he wanted to pay no taxes on the estate. A 100% QTIP election was made for the trust and the wife's return utilized none of her unified credit. In the husband's estate, the estate argued that the gross estate does not include the QTIP property since the income payment terms permitted accumulation and the election earlier made was improper. The Tax Court (100 TC 407) had held for the Service and the appeals court affirmed. The terms of the wife's trust gave her husband sufficient income rights. The trust, according to the Court of Appeals, should be construed as giving husband the right to income at least annually for life but with the trustee having some discretion to the timing of the payments.

In the early years of the QTIP provisions, the IRS took the position that a will provision that diverts assets from a martial trust to a bypass trust, to the extent that the executor fails to make a QTIP election, disqualifies the trust. Treas.Reg. §20.2056(b)-7(c)(1). In *Estate of Spencer v. Comm*., 43 F.3d 226, 231-232 (6th Cir. 1995), the Sixth Circuit has joined the Fifth Circuit in *Estate of Clayton v. Comm*., 976 F.2d 1486, 1487-1488 (5th Cir. 1992), and the Eighth Circuit in *Estate of Robertson v. Comm*., 15 F.3d 779, 781-782 (8th Cir. 1994), in holding that a gift to a spouse did not fail to qualify for the marital deduction simply because it was elected by the executor. In *Estate of Willis E. Clack*, 106 TC 131 (1996), the Tax Court reversed its prior decisions and followed the appeals courts. The IRS will no longer litigate the issue, A.O.D. 1996-2 CB 1. A review of these cases suggests broad availability of the marital deduction.

Clayton reversed the Tax Court's denial of the marital deduction where the decedent's will provided that any property for which the QTIP

election was not made on marital deduction Trust B was to pass to and be added to the credit shelter, Trust A, of which decedent's children were the beneficiaries. The surviving spouse and a bank were named in the will as independent co-executors and co-trustees, but the bank requested appointment by the court as co-trustee, but that it be permitted to file its oath and be qualified only after the surviving spouse, as sole executor, filed the estate tax return. She checked the appropriate box on Schedule M to elect a marital deduction for QTIP. The IRS disallowed the marital deduction on Trust B as did the Tax Court, 97 TC 327. The executor's power to make partial election didn't invalidate QTIP even though property for which no election was made would pass to nonqualified trust. The surviving spouse's interest was found to be in QTIP property, not the entire residuary estate, so the partial QTIP election wasn't impermissible termination of her qualified interest. The disposition of property for which no election was made, and no deduction taken, was irrelevant in determining whether elected property qualified for QTIP treatment. The QTIP exception should not be interpreted narrowly, because it is an exception to the terminal interest exception to the marital deduction and should enjoy the same favored position and liberal construction as is properly afforded to the marital deduction itself.

If the executor is not the spouse, but a beneficiary of the trust to be funded if the QTIP election is not made, does making the QTIP election cause the executor to make a gift? If the executor is the spouse and not a beneficiary of the trust to be funded if the QTIP election is not made, does not making the QTIP election cause the executor-spouse to make a gift? Probably not. *Clayton and Robertson* both held that the election relates back to the date of death, which would indicate no gift. *Spencer* held that the election relates to the day it is made, opening the possibility of a gift, but *Clack* said it need not decide when it relates, because the result is the same, suggesting no gift. There are fine practitioners who believe a gift is present in these situations.

Estate of Rinaldi v. U.S., 80 AFTR2d 97-5324 (Ct. Cl. 1997), involved whether a transfer in trust for the benefit of the decedent's spouse qualified for QTIP treatment. The decedent bequeathed to a trust for the benefit of the surviving spouse all of the stock in a close corporation. All of the net income was to be paid annually to the decedent's spouse, while the trust corpus was distributable outright to the decedent's son upon her death. The trust agreement specifically authorized the decedent's son, as trustee, to continue in the daily management of the company, vote all of the stock of the company held by the trust and, if the decedent's son ceased to be involved in daily management of the company, to sell the trust stock to the decedent's son at book value. The court ruled that the bequeathed shares did not qualify for the QTIP election. The son's power if he ceased to be involved in daily management of the company to purchase the shares at book value and effectively to diminish the value of the corpus, the IRS argued, violated the QTIP requirement that no person have a power to appoint any part of the property to any person other than the surviving spouse. Prior to the QTIP election, the shares were redeemed by the company so the son had no right to purchase them at a bargain price. The court held that qualification for the marital deduction must be determined as of the time of the testator's death. Also, nothing prohibited the trust from reacquiring the shares and renewing the son's right to purchase.

The preparer should carefully examine the terms of any trust to make sure it meets the QTIP requirements or through disclaimer can be made to so qualify.

[2] When made

The election is to be made on the last estate tax return filed by the executor on or before the due date of the return, including extensions, or if a timely return is not filed, the first estate tax return filed by the executor after the due date. Treas. Reg. §20.2056(b)-7(b)(4). If a Form 706 is filed without the election, an amended return to make the election may not be filed unless the amended return is filed on or before the due date for filing the original return. Form, Schedule M, p. 29.

Treas. Reg. §301.9100-1 through 301.9100-3 provide standards under which the Service can determine whether to grant an extension of time to make an election. Under Treas. Reg. §301.9100-1(c) the Service may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more that 6 months except in the case of a taxpayer who is abroad). Treas. Reg. §301.9100-3 provides relief when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. Treas. Reg. §301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election. PLRs 2004101011 and 200411038 under this regulation gave estates extensions of time to make a QTIP election.

[3] Election irrevocable

The QTIP election is irrevocable, IRC § 2056(b)(7)(B)(v), except that an election may be revoked or modified on a subsequent return filed on or before the due date of the return including extensions actually granted. Treas. Reg. §20.2056(b)-7(b)(4)(ii). In PLR 200422050 an estate sought a partial revocation of a QTIP election previously made, and Treas. Reg. §301.9100-3, under which the estate sought relief, did not apply.

[4] Partial election

If less than all of the value of an item listed on Schedule M is deducted, the QTIP election is partial and is made as to a fractional share of the asset, the numerator of the fraction being the amount deducted on Schedule M and the denominator equal to the item's total value as reported on the appropriate asset schedule of the return. A partial QTIP election will expose a portion of the trust to estate taxes in the estate of the first to die. This power is held by the executor. The QTIP election may be made for a part of the trust only if the election relates to a defined fraction or a percentage of the entire trust. IRC §2056(b)(10); Treas. Reg. §20.2056(b)-5. The fraction or percentage may be defined by means of a formula. Form, Schedule M., p. 29. When otherwise nondeductible property for which a QTIP election is to be made is listed on Schedule M, the QTIP election will be considered made for all of the trust or other property unless the fractional portion of the trust not subject to the election is specifically identified. Form, Schedule M, p. 20. It is preferable to make a division of the qualified terminable interest property prior to making the election and make the election as to the whole of the already divided trust.

[a] Formula use

When a partial QTIP election is made in order to have the maximum amount that can pass free of tax not subject to the marital deduction, the QTIP election should be made by use of a formula rather than a pecuniary (dollar) amount or specific assets. Without a formula, changes in value, in non-marital deductions or in lifetime adjusted taxable gifts may require a change in the amount of the QTIP election to obtain the desired result. Here is an example of a formula:

> A fraction of the Marital Trust equal to the maximum federal estate tax marital deduction available minus the value for federal estate tax purposes of all items in the gross estate which qualify for the marital deduction and which pass or have passed to Decedent's surviving spouse in a form qualifying for the marital deduction otherwise than under this gift, using values as finally determined for federal estate tax purposes, reduced by the amount, if any, needed to increase the taxable estate to the largest amount that will result in no federal estate tax payable by the estate after allowing for the exemption equivalent amount but no other credit.

This fractional formula is based upon Example 7 of Treas. Reg. §20.2056(b)-7(h).

> A fractional share of the residuary estate the numerator of the fraction is the amount of the deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate).

The regulation states that the value of the share qualifies for the marital deduction even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.

The importance of making a formula election is illustrated in PLR 200450004 where the accountant preparing the return miscalculated the amount of the surviving spouse's one-third statutory share. The surviving spouse elected to receive her one-third statutory share of her husband's estate and the accountant made a QTIP election for "100% of Decedent's property passing to Spouse in accordance with her statutory share." The IRS held that the error may be corrected with a supplemental estate tax return, because the intention to make the QTIP election for the full amount of the spouse's share was disclosed adequately on the return.

[5] QTIP trust division

Where a partial election is made, division of the trust into an elected trust and a non-elected trust facilitates accounting for the separate shares of the trust in the event of principal distributions to be made only from the elected portion of the trust. Treas. Reg. §20.2056(b)-7(b)(2)(ii) permits division of a trust into separate trusts to reflect a partial election that either has been made or will be made provided division is authorized under the trust instrument or under local law. When the trust has not yet been divided at the time of filing the estate tax return, the intent to divide the trust must be unequivocally signified on the estate tax return and such division must be accomplished no later than the end of the period of estate administration. The division of the trust must be done on a fractional or percentage basis to reflect the partial election, but the separate trusts need not be funded with a pro rata portion of each assets held by the undivided trust. Either applicable local law or the express or implied provisions of the trust instrument must require that

the division of the trust assets be based on fair market value of the assets at the time of the division.

[6] Defective elections

Litigation guideline memorandum, LGM TL-82, 2000 TNT 121-63, addressed the position to be taken in cases involving defective QTIP elections under IRC § 2056(b)(7). Cases meeting the stated criteria are to be disposed of by a closing agreement under which the marital deduction will be allowed on the condition that the executor of the decedent's estate agrees that the property will subsequently be included in the surviving spouse's gross estate under IRC § 2044. Further, an attempt is to be made for the surviving spouse to sign the closing agreement to strengthen the agreement that the property is includable in the surviving spouse's estate. Under the 1987 version of Form 706 and Schedule M, the closing agreement is to be made available if (i) the property is listed on Part 2 of Schedule M, but the box is not checked, or (ii) the box is checked, but the property is listed on Part 1 of Schedule M. In cases where the box is checked, but no property is listed on Schedule M, the closing agreement procedure is not to be made available.

In Rev.Proc. 2001-38, 2001-28 I.R.B. 1335, the Service announced it will treat a QTIP election as null and void for purposes of IRC § 2056(b)(7) when the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero. See PLRs 200318039 and 200443027 for private letter rulings in which the revenue procedure was favorably applied to void an election. In PLR 200219003, the IRS ruled that a QTIP election was required with respect to the marital trust to reduce the decedent's estate tax liability to zero. However, in that case, the taxpayer made the election for more marital trust property than was necessary in order to reduce the decedent's estate tax liability to zero. Yet that situation was specifically excluded from the purview of Rev.Proc. 2001-38 and, accordingly, the QTIP election with respect to 100% of the marital trust was valid and effective for estate tax purposes. Therefore, 100% of the value of the marital trust on the applicable valuation date was includable in the spouse's gross estate under IRC § 2044. A similar ruling was made in 200422050.

In PLR 200436001 an extension of time to make a QTIP election was granted pursuant to Treas. Reg. §301.9100-1 and Treas. Reg. §301.9100-3.

In PLR 200323010, the IRS ruled that an undervaluation of the value of the property passing to the marital trust and eligible for the QTIP election both did not invalidate the QTIP election for the marital trust and it did not preclude the marital deduction for the full value of the property that would actually fund the marital trust. The estate's personal representative was instructed to file a supplemental estate tax return reporting the full value of the marital property subject to the QTIP election prior to the time prescribed by IRC § 6511 for claiming a refund or credit.

[7] Protective elections

If at the time of filing the estate tax return, it remains uncertain if a property interest will be funded, and if fund, the property interest will in all respects qualify for QTIP treatment (provided its elected), then the property interest may be made subject to a protective election.

First Security Bank of Southern New Mexico v. U.S., 87 AFTR 2d Par. 2001-934 (D.N. Mex. 2001), illustrates the benefits of a protective election. Decedent created an inter vivos trust for her husband and she explicitly provided that the gift was to be elected as QTIP. No timely QTIP election was made on a gift tax return. The instrument creating the inter vivos QTIP revoked a testamentary QTIP trust, conditioned on the inter vivos trust qualifying for QTIP. When decedent died, the IRS assessed gift tax on the inter vivos QTIP because it has not been properly elected. The estate paid the gift tax and sued for refund, claiming that the inter vivos gift was explicitly conditioned on being elected for QTIP and when it failed, the property properly passed to the testamentary trust, which was QTIP and for which a protective election had been made. The district court agreed with the estate's contention that the inter vivos QTIP failed and the protective election in the testamentary QTIP made the marital deduction available.

[8] Reverse QTIP election

In the case of property for which a marital deduction is allowed to the decedent's estate under IRC § 2056(b)(7) (QTIP election), IRC § 2652(a)93) allows the executor to treat such property for purposes of the GST tax as if the election to be treated as QTIP had not been made, the "reverse QTIP election." The IRC § 2652(a)(3) election must include the value of all property in the trust for which a QTIP election was allowed under IRC § 2056(b)(7) and cannot be partial. If a IRC § 2652(a)(3) election is made, then the decedent will for GST tax purposes be treated as the transferor of all the property in the trust for which a marital deduction was allowed to the decedent's estate under

IRC § 2056(b)(7). In this case, the executor of the decedent's estate may allocate part or all of the decedent's GST exemption to the property. The significance of this occurs upon the death of the surviving spouse; the trust will be included in the survivor's estate for estate tax purposes, but the exemption allocated in the decedent's estate will not be lost. As a result of EGTRRA 2001, in 2004 the estate tax amount and the GST exclusion will be numerically equivalent, and there will be reduced need to utilize the "reverse QTIP election" under IRC § 2652(a)(3). This election is made on Schedule R and nothing is required for the GST reverse QTIP election on Schedule M.

[9] Severance and assignment of QTIP

In PLR 200223047, the IRS ruled as to a proposed severance of a QTIP trust and assignment of a severed portion of the trust to the beneficiary's daughters. On the estate tax return for the decedent, an election was made to treat a marital trust as a QTIP trust. The surviving spouse and the trustee of the marital trust proposed to petition the court to sever the marital trust into two trusts, a Marital Trust A and a Marital Trust B. The terms of the trust would be similar but not necessarily would they be funded equally. Subsequent to funding, the spouse would renounce her entire interest in Marital Trust B. In an assignment that would incur gift tax on the spouse's part, but pursuant to an agreement that she would pay the gift taxes and she would recover the gift taxes paid from Marital Trust B, the IRS ruled that the proposed severance of the QTIP trust would not affect the QTIP election's validity as to Marital Trust A. The Service further ruled that the property transferred to the beneficiaries would not be included in the spouse's gross estate under IRC § 2044(b)(2).

[10] Basis increase

In planning the QTIP trust uncertainty is created by the scheduled repeal of the federal estate tax in 2010 and the limited basis increase available under new IRC § 1022. Property must be owned by the decedent to be eligible for the basis adjustment, but holding a special or general power of appointment over property does not amount to owning the property for purposes of the basis increase. Property passing from a QTIP trust at the surviving spouse's death will not be eligible to receive any basis increase upon the surviving spouse's death.

[C] Charitable remainder trusts

An interest in a charitable remainder annuity trust or a charitable remainder unitrust will not be treated as a nondeductible terminable interest if these conditions are satisfied:

(i) The interest in the charitable remainder trust passes from the decedent to the surviving spouse; and

(ii) The surviving spouse is the only beneficiary of the charitable remainder trust other than charitable organizations described in IRC § 170(c). Form, Schedule M, p. 29.

[D] Reformation

In the Estate of *Bert Rapp v. Comm.*, TCM (CCH) 1709 (1996), *aff'd.* 140 F.3d 1211 (9th Cir. 1998), the Tax Court held that a reformation under California law of a trust to qualify as a QTIP trust was not effective. The trust provided that principal and interest could be distributed for the health, education, and support of the surviving spouse in the discretion of the co-trustees, who were the sons of decedent. The reformation provided that all the income would be distributed annually. The court found that the spouse did not have the right to income annually under the terms of the trust, interpreting California law. The Tax Court held that under California law, extrinsic evidence of a testator's intent could be admitted to show a provision in the will was ambiguous, but the will in this instance was not ambiguous.

In PLR 200106008, a reformation was recognized as providing the widow a qualifying income interest for life in a marital trust that was a qualified deduction. The husband's will established a marital trust in which the trustee had the power to appoint the principal of the trust to persons other than the widow and the widow's income interest did not qualify for the marital deduction. In the widow's reformation petition, she represented that the will contained a scrivener's error by including language in the marital trust that permitted discretionary principal payments to descendants when it was the husband's intent to have that provision included elsewhere. It also was the husband's intent to have the assets passing to the marital trust qualify for the marital deduction under IRC § 2056. The state court reformed the marital trust to correct the scrivener's error and to effectuate the husband's intent. The IRS, following *Comm. v. Bosch*, 387 U.S. 456 (1967), ruled that the court order reforming the will was consistent with the applicable state law as it would be applied to the highest court of the state and the marital trust as reformed gave her an income interest that qualified for the marital deduction.

If the "reformation" can be accomplished by a qualified disclaimer, then the marital deduction will be recognized.

§16.05 *Amount of deduction to be taken*

To the extent that the executor and/or the spouse have the ability to determine the amount of the

deduction to be taken on the estate tax return, there are several reasons and methods for not maximizing the marital deduction.

[A] Rate progressivity

Progressivity in the estate tax brackets results in lower total federal estate tax if some tax is paid at the first death and some at the second death where the combined estates of both spouses exceed $2 million (2003) or $3 million (2004).

[B] Credit for tax on prior transfers

Where the surviving spouse has a short life expectancy, the credit for tax on prior transfers may make payment of tax in the first estate cost effective. See discussion below.

§16.06 *Disclaimers and the marital deduction*

Much creative planning can be done with disclaimers to increase the amount of the marital deduction, decrease the amount of the marital deduction, to remove an intervening interest that disqualifies the interest for the marital deduction and thus qualify it, and to remove an interest that disqualifies the interest for QTIP treatment.

For example, if a beneficiary other than the spouse has an interest prior to the surviving spouse, a qualified disclaimer by the intervening beneficiary may remove the intervening interest so the bequest to the surviving spouse qualifies. To further illustrate, if the will says $1 million to decedent's son, and if the son does not survive then to decedent's spouse, a qualified disclaimer by son can remove the son's intervening interest, so the $1 million passes directly from the decedent to the surviving spouse and the gift qualifies for the marital deduction.

[A] Qualified disclaimer requirements

The requirements of a qualified disclaimer are set forth in the section "Disclaimers" of Chapter 1, "General Matters."

[B] Required disclaimer questions

In the middle of the first page of Schedule M, a disclaimer question is asked:

> "Did any property pass to the surviving spouse as a result of a qualified disclaimer?" If "yes," attach a copy of the written disclaimer required by Section 2518(b).

[C] Private letter rulings on disclaimers

Here are some private letter rulings that illustrate how disclaimers can be used in preparing the estate tax return to[1] obtain the desired result. On some of these situations your author would not have bothered to obtain a private letter ruling, because the law appears to be sufficiently clear, but remember that a private letter ruling is only good for the taxpayer who requests it, so if there is a potential issue or any doubt, get your own private letter ruling.

[1] Increase the marital deduction

(1) In PLR 8145036, pretermited children executed formula disclaimers so that property would pass the surviving spouse.

(2) In PLR 8409089, intestate beneficiaries other than the surviving spouse disclaimed so property passed to the surviving spouse.

(3) In PLR 8514095, children disclaimed by formula property other than that sheltered by unified credit. PLR 8439007, the same.

(4) In PLR 8610033, decedent left the residue of his estate in five equal shares to his four sons and his spouse, but disclaimers by the sons left the spouse as the only residuary beneficiary. PLRs 9251019 and 9051007 similar.

(5) In PLR 8625001, children on joint bank accounts and certificates of deposit disclaimed their interests so it passed through probate estate on to surviving spouse.

[2] Remove intervening disqualifying interests

Disclaiming an interest held by persons other than the spouse, may let the property pass by intestacy and qualify for the marital deduction.

(1) In TAM 9301005, the decedent left his residence to his wife for as long as she wished to occupy it, and when all of the remaindermen disclaimed, the residence passed by intestacy to the surviving spouse.

(2) In PLR 8301040, the surviving wife was given the income from property until the earlier of her death or remarriage, and the daughter's disclaimer passed the property by intestacy to the surviving spouse.

(3) In PLR 200006052, decedent's joint will passed all property outright to wife, but upon wife's remarriage, one-half of the property was to immediately pass to child and, upon death, all the remainder was to pass to child, or if child did not survive, to child's issue and, in the absence of issue, to a named charity. Disclaimers by wife, son (of amounts over the unified credit amount) and charity, passed the property to spouse by intestacy.

[3] To create QTIP trust

It may be advantageous to have a QTIP marital trust rather than a general power of appointment marital deduction trust, so a partial QTIP election

[1] Most of these examples were taken from Thompson "Disclaimers" When, Why & How to Say No to an Inheritance," ACTEC Summer Meeting, 2001.

can be made as a reverse QTIP election for marital deduction purposes.

(1) In PLR 9043055, a surviving spouse disclaimed a general power of appointment resulting in the marital trust meeting the requirements for QTIP.

(2) In *Estate of Avery*, 476 N.Y.S2d 1013 (Sur. Ct. 1984), to qualify half a trust for QTIP treatment, the daughter disclaimed half of the right to receive income remaining at wife's death, causing it to pass to the wife as daughter's heir at law, satisfying the requirement that stub income be paid at death to wife's estate. Upon splitting the trust, the trust for the wife qualified for QTIP treatment.

(3) In *Estate of Lassiter v. Comm'r*., 80 TCM (CCH) 541 (2000), disclaimers by permissible recipients of principal invasions by the trustee eliminated the power in the trustee to invade the trust for someone other than the surviving spouse. Disclaimer by the trustee alone will probably be insufficient for the trust to qualify. There are numerous PLRs:

PLRs	8609014	199949023
8309030	8637044	200030012
9337069	8638016	TAMS
8429085	8725036	8443005
8508009	8815038	8546007
8543009	8906036	8618067
8544019	9119047	9247002
935024	9148021	
9148018	9226059	

[4] Increase QTIP trust

In PLR 200105058 the surviving wife was named as the primary beneficiary of her deceased husband's qualified pension plan and a ATIP trust was named as the contingent beneficiary. She disclaimed her interest in the qualified plan, as well as a special power of appointment in the QTIP trust, and the IRS ruled that these were qualified disclaimers and the pension passed to a QTIP trust that qualified for the marital deduction.

§16.07 *Qualified domestic trusts (QDOTs)*

Where the surviving spouse is not a U.S. citizen, the marital deduction is allowed only if the property passes to the surviving spouse in a qualified domestic trust (QDOT) or if such property is transferred or irrevocably assigned to a QDOT before the decedent's estate tax return is filed. Form, p. 29-30.A trust not meeting all of the requirements of a QDOT may be reformed after decedents death to meet QDOT requirments. Treas. Reg. § 20.2056A-1(a)(1) and § 20.2056A-4(a).

Practical points. To obtain the disclaimer of a charitable organization or a minor as part of multiple disclaimers, seek their disclaimer first, while the interest is of little or no value.

In the above disclaimer, upon the disclaimer of wife, son took and the remainder to the charity had no value. Seek the charity's disclaimer before seeking the disclaimer of the son.

If son had minor issue, their disclaimer, when son was alive, was a disclaimer of an interest that would not result in the minors taking. Disclaimer before the son disclaims is a disclaimer of an interest without value.

[A] QDOT defined

A QDOT is any trust:

(i) that meets the general requirements of QTIP trusts;

(ii) that requires at least one trustee to be either an individual who is a citizen of the United States or a domestic corporation (for decedents dying after August 5, 1997, the Treasury Department was given regulatory authority to permit establishment of a QDOT in countries which prohibit a trust from having a U.S. trustee);

(iii) that requires that no distribution of principal from the trust can be made unless such a trustee has the right to withhold from the distribution the tax imposed on the QDOT;

(iv) that meets the requirements of any applicable regulations; and

(v) for which the executor has made an election on the estate tax return of the decedent. Form, Schedule M, p. 30.

The above definition and the following explanation can only be described as brief condensation of the extensive QDOT requirements set forth in numerous pages of regulations, Treas. Reg. §20.2056A-1, *et. seq.*

[B] How QDOT election is made

The QDOT election is made by listing the qualified domestic trust or the entire value of the trust property on Schedule M and deducting its value. The QDOT election is presumed to have been made if the trust or trust property is listed and its value deducted on Schedule M. When listing a trust for which a QTIP election is made, unless the trust is specifically identified as not subject to the election, the election will be made for the entire trust. Form, Schedule M, p. 27.

[C] Required information

The instructions state that the following information should be provided for each QDOT on an attachment to Schedule M:

1. The name and address of every trustee;
2. A description of each transfer passing from the decedent that is the source of the property to be placed in the trust; and
3. The employer identification number (EIN) for the trust.

Form, Schedule M, p. 30.

Interestingly, the instructions do not require proof of the U.S. citizenship of the trustee.

[D] When determination is made

The determination of whether a trust qualifies as a QDOT will be made as of the date the Form 706 is filed. If before the Form 706 due date, including extensions, judicial proceedings are brought to have the trust revised to meet the QDOT requirements, then the determination will not be made until the court-ordered changes to the trust are made. Form, Schedule M, p. 30.

[E] Outright transfers and QDOTs

Outright transfers to a non-citizen spouse, no matter the value, does not qualify for the estate tax marital deduction, but if such property is actually transferred or irrevocably assigned by the surviving spouse to a trust meeting the QDOT requirements, whether created by the decedent, the decedent's executor or by the surviving spouse, it will meet the requirements for the marital deduction in the decedent's estate. Treas. Reg. §20.2056A-2(b)(2).

[F] Non transferable assets

A marital deduction can be obtained for annuities, individual retirement accounts, other retirement benefits and other assets that cannot easily be transferred into a QDOT, by special arrangements entered into with the IRS, but require posting a bond and paying an estate tax on all principal distributions. The cumbersome requirements are set forth in the regulations, Treas. Reg. §20.2056A-4(b).

[G] Trustee requirements and security arrangements

As stated previously, the QDOT must have at least one U.S. trustee. If the QDOT has more than $2 million in assets, there must be a U.S. corporate trustee, unless a letter of credit or a bond is posted. The regulations set forth in detail the form of the bond or the letter of credit, if those forms of security are utilized. Treas. Reg. §20.2056A-2(d).

[H] Tax on distributions

An estate tax deduction under IRC § 2210(b)(1) is levied upon principal distributions from a QDOT made before the spouse becomes a U.S. citizen or when the spouse should become a citizen outright distribution or conversion to a QTIP will not be a taxable event. Before becoming a citizen, the spouse can receive hardship distributions from proncipal without estate tax if the spouse does not have sufficient income or assets of the spouse's own sufficient to meet the spouse's need. IRC § 2056 A(b)(3)(B).

[I] QDOT and repeal

The Federal estate tax is repealed after 2009, except that IRC § 2210(b)(1) preserves the estate tax under IRC § 2056A(b)(1)(A) on distributions prior to the year 2021 to a surviving spouse from a QDOT during the spouse's life if the deceased spouse died before 2010. The trust would not be subject to tax upon the surviving spouse's death. The rationale for preserving the QDOT tax for eleven years on lifetime distributions was due to the budgetary cost of estate tax repeal. Beth S. Kaufman, *Comment*, PHILLIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, January 8, 2002.

§16.08 *Listing on Schedule M*

[A] Required questions

In the middle of the first page of Schedule M, this question is asked:

> 3. **Election Out of QTIP Treatment of Annuities**. – Do you elect under section 2056(b)(7)(C)(ii) **not** to treat as qualified terminable interest property any joint and survivor annuities that are included in the gross estate and would otherwise be treated as qualified terminable interest property under section 2056(b)(7)(C)?

IRC § 2056(b)(7) creates an automatic QTIP election for certain joint and survivor annuities that are includable in the estate under IRC § 2039. To qualify for automatic QTIP treatment, only the surviving spouse can have the right to receive payments before the death of the surviving spouse.

The election out is made by answering the above question "yes" and, once made, the election is irrevocable. If there is more than one joint and survivor annuity, the election can be made as to one or more and not as to others. If you elect out as to an annuity, it is not listed on Schedule M, but any annuity not elected out must be listed on Schedule M.

[B] Descriptions

Each property interest to be deducted is to be described in detail. The instructions require a description of the instrument (including any clause or paragraph number) or the provision of law under which each item passed to the surviving spouse. The item number and schedule where the property is

listed on Schedules A through I is to be shown. Form, Schedule M, p. 30.

[1] Computation of deduction

The instructions state that if Schedule M includes a bequest of all or part of the residue of the decedent's estate, to attach a copy of the computation showing how the value of the residue was determined. The computation is to include:

[a] The value of all property included in the decedent's gross estate (listed on Schedules A through I), but not a part of the decedent's probate;

[b] The values of all specific and general legacies or devises, with reference to the applicable clause of the decedent's will or codicil;

[c] The date of birth of all persons, the length of whose lives may affect the value of the residuary interest passing to the surviving spouse; and

[d] Any other important information such as that relating to any claim to any part of the estate not arising under the will. Form, Schedule M, p. 30.

[2] Computation of tax

The instructions also state that the total of the values listed on Schedule M must be reduced by the amount of the federal estate and GST taxes and the state estate, GST or death taxes paid out of the property. The taxes are to be identified and a computation attached. *Id.*

§16.09 *Attachments*

[A] Order admitting will

A certified copy of the order admitting the will to probate must be attached if the Schedule M property passes by the will. Form, Schedule M, p. 30.

[B] Decree interpreting will

If the probate court has entered a decree interpreting the will or any of its provisions affecting any of the interests reported on Schedule M, attach a copy of the decree. Form, Schedule M, p. 30.

[C] Order of distribution

If the probate court has entered an order of distribution, attach a copy of the order. Form, Schedule M, p. 30.

[D] Disclaimers

The instructions state that if property passes to the surviving spouse as a result of a qualified disclaimer, the "Yes" box on line 1 is to be checked and a copy of the written disclaimer attached. A disclaimer *by* the surviving spouse apparently need not be attached.

§16.10 *On audit*

On audit the examining agent is instructed to inquire as follows:

> Is the will or trust instrument valid, i.e., has the will been probated, was the trust instrument properly executed and funded, was the surviving spouse legally married to the decedent and, in rare cases, did the "surviving" spouse actually survive the decedent?
>
> Examiner's Handbook, Section (17)20(1).

17 SCHEDULE O - CHARITABLE, PUBLIC AND SIMILAR GIFTS AND BEQUESTS

§17.01 *Charitable transfer deduction*

The charitable deductions under IRC § 2055 can be taken for the value of property in the decedent's estate that was transferred by the decedent during life or by will to or for the use of a charitable organization described in IRC § 2055. Early in the preparation of the return contributions to charitable organizations should be reviewed to determine if the named organization is a qualified Section 2055 organization and if the form of the gift qualifies. Disclaimers or reformation may result in qualification for the charitable deduction of an otherwise non-deductible transfer. A declaratory judgment action may be required to determine the proper recipient, when wills and testamentary documents contain ambiguous designations. Reformations and court actions as they relate to the charitable deduction are discussed below.

[A] Section 2055 organizations

The Instructions, p. 17, set forth the following descriptive list of IRC § 2055 organizations:

- **Government.** The United States, a state, a political subdivision of a state, or the District of Columbia, for exclusively public purposes [Certain Indian tribal governments are treated as states and transfers to them qualify as deductible charitable contributions. *See* Rev. Proc. 83-87, 1983-2 CB 606, as modified and supplemented by subsequent Revenue Procedures for a list of qualifying Indian tribal governments]; Property that escheats to a state does not qualify for the deduction because the property is not considered to be transferred by the decedent as required in Treas. Reg. §20.2055-1(a). Transfers to foreign governments or U.S. territories are not included here.
- **Charitable organizations.** Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement

of art, or to foster national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment, unless the organization is a qualified amateur sports organization) and the prevention of cruelty to children and animals, as long as no part of the net earnings benefits any private individual and no substantial activity is undertaken to carry on propaganda, or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office;

- **Noncharitable organizations for charitable purposes.** A trustee or a fraternal society, order or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, and no substantial activity is undertaken to carry on propaganda or otherwise attempt to influence legislation, or participate in any political campaign on behalf of any candidate for public office;
- **Veterans' organizations.** Any veterans' organization incorporated by an Act of Congress or any of its departments, local chapters, or posts, for which none of the net earnings benefits any private individual; or
- **Foreign governments for charitable purposes.** A foreign government or its political subdivision when the use of such property is limited exclusively to charitable purposes. Rev. Rul. 74-523, 1974-2 CB 304, provides that a charitable deduction is allowable for a charitable bequest to a foreign government where the bequest is to be used for exclusively charitable purposes under IRC § 2055. In PLR 7938001 the Service ruled that no charitable deduction was allowable for a bequest to the State of Israel that was reformed by the probate court to be limited to exclusively charitable purposes. In PLR 8929001 a bequest to a foreign country and not restricted to exclusively charitable purposes still did not qualify for the estate tax charitable deduction when the foreign government had an internal procedure that requires general bequests to the government to be used solely for charitable purposes. The same ruling was reaffirmed in PLR 9004001.

Check the *Cumulative List of Organizations*, published by the IRS, or go online to the IRS website "http://www.irs.gov." A conservative preparer may request a copy of the organization's tax exemption letter when the organization does not have a local or national reputation as an IRC § 2055 organization. Most traditional churches with "church" in their name may not have a tax exemption letter, such as the First Baptist Church or St. Mark's Episcopal Church, but frequently a non-traditional church will have an exemption letter.

[B] Charitable purpose

Sometimes a charitable purpose must be a part of the bequest. For example, an estate was not entitled to a charitable deduction for the decedent's bequests to Masonic and fraternal organizations because there was no evidence that the organizations intended to use the gifts exclusively for charitable purposes. *L. Cavett Estate*, 79 TCM (CCH) 1662 (2000).

The IRS has ruled that a bequest for the purpose of rebuilding a mosque located in, and owned by, a foreign country qualified for the charitable deduction. The will restricted the use of the fund to charitable purposes. PLR 200024016.

In *Estate of Starkey v. U.S.*, 223 F.3d 694, 700 (7th Cir. 2000), the Seventh Circuit reversed a district court and allowed an estate to qualify for a charitable deduction. The decedent created a charitable trust that provided for "missionaries preaching the gospel of Christ, and Milligan College." The IRS denied the deduction because the provision for missionaries could permit the trustees to make distributions to virtually anyone claiming that faith and the funds could be used for private purposes. The appeals court interpreted "missionaries" as limited to those supported by decedent's church. Creative administration saved this deduction.

Where part of the decedent's charitable purpose fails, a clear charitable purpose can save the charitable deduction. In PLR 2001120007, the decedent provided that an historically significant structure was to pass upon his death to a private operating foundation he created to preserve the property as a public museum and garden, provided the foundation was qualified as a tax-exempt organization and had obtained certain local use permits. Even though the necessary permits had not been obtained at decedent's death, the IRS held that the transfer was nevertheless deductible under IRC § 2055(a)(2) because the private foundation was a tax exempt charitable organization under IRC § 501(c)(3), the local political situation limiting public access did not detract from the foundation's charitable purpose of preservation of the structure, and the default gift was to a qualified IRC § 501(c)(3) organization.

Still, the charitable deduction depends upon transfer to a qualified charity rather than on the use to which the non-qualified entity or person may put the money. *See, John Danz Charitable Trust v. Comm.*, 231 F.2d 673, 676 (9th Cir. 1955), aff'g, 18 TC 454 (1952). Attaching charitable limitations to a

transfer to a non-qualified charity or to an individual person will not save the deduction.

[C] Bequests to unnamed charities

In LTR 9634025, the Service ruled that a decedent's bequests to unnamed religious charities are eligible for a federal estate tax charitable deduction under Section 2055(a)(3). The decedent's will provided that specific portions of a trust corpus pass to Catholic (80 percent), Protestant (10 percent), and Jewish (10 percent) charities "as shall be chosen by the trustee." The trust was governed by New York law. The Service explained that under Rev. Rul. 69-285, 1969-1 CB 222, property passing under a decedent's will is eligible for the charitable deduction if (1) the terms of the bequest could be construed to impose a trust on the property under state law, and (2) distribution of property would be restricted under state law to charitable organizations within the meaning of IRC § 2055(a). The IRS determined that New York courts would impose a trust on the assets at issue and would require the trustee to transfer the assets to charitable beneficiaries.

[D] Cemeteries

An estate tax charitable deduction is allowable for a bequest to or for governmental or church-owned cemeteries. No deduction is allowed for a bequest to a nongovernmental or non-church-owned cemetery engaged in the business of selling burial lots, even if the cemetery association is tax exempt. *Estate of Vesta Alward v. Comm.*, 78 TCM (CCH) 243 (1999).

[E] Conditional transfers

The regulations may limit the deduction where strings are attached.

> **Transfers subject to a condition or a power**
>
> *(1)* If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity at the time of a decedent's death and the estate or interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appeared at the time of the decedent's death to be so remote as to be negligible, the deduction is allowable. If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.
>
> *(2)* The application of this paragraph may be illustrated by the following examples:
>
> *Example (1):* In 1965, "A" dies leaving certain property in trust in which charity is to receive the income for the life of his widow. The assets placed in trust by the decedent consist of stock in a corporation the fiscal policies of which are controlled by the decedent and his family. The trustees of the trust and the remaindermen are members of the decedent's family, and the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not members of the decedent's family but have no power to sell or otherwise dispose of the closely held stock, or otherwise ensure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.
>
> *Example (2):* "C" dies leaving a tract of land to a city government for as long as the land is used by the city for a public park. If the city accepts the tract and if, on the date of C's death, the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.
>
> Treas. Reg. §20.2055-2(b).

Where the disqualifying power is held by an individual, a disclaimer, discussed above, may make the deduction available, or if the disqualifying power is terminated, discussed below, the deduction may be made available.

[F] Terminations

The charitable deduction is allowed for amounts that are transferred to charitable organizations as a result of the complete termination of a power to consume, invade, or appropriate property for the benefit of an individual, regardless of whether the termination occurs because of the death of the individual or in any other way. The termination must occur within the period of time (including extensions) for filing the decedent's estate tax return and before the power has been exercised.

[G] Split interests

Charitable and non-charitable split interests (*e.g.* a life income interest to decedent's son and remainder to a qualified charity in a trust) will not qualify for a charitable deduction under IRC § 2055(e)(2), unless the split interests are a charitable remainder annuity trust, a charitable remainder unitrust, a pooled income fund, a charitable lead annuity trust, or a charitable lead unitrust. Certain

remainder interests in a personal residence or farm may also be deducted. For art, a contribution of art with retention of the copyright is not considered a split-interest.

[1] CRTs, CLTs, and pooled income funds

The technical requirements of a charitable remainder unitrust, a charitable remainder annuity trust, a charitable lead annuity trust, or a charitable lead unitrust, are beyond the scope of this work. The technical requirements are set forth in Conrad Teitell, *Deferred Giving and his Charitable Lead Trusts.* Here are brief explanations:

Charitable remainder unitrusts pay a fixed percentage between five and fifty percent of the net fair market value of the trust assets valued annually to one or more individuals for a term of years not to exceed 20 or for the life or lives of persons receiving the unitrust amount. Following the non-charitable terms the remaining trust assets are transferred to or held for the use of charity. When the unitrust was created, the actuarial value of the remainder interest must be at least 10-percent of the net fair market value.

Charitable remainder annuity trusts are trusts from which a fixed dollar amount of between five percent and fifty percent of the initial fair market value of the property placed in trust upon creation is paid at least annually to one or more individuals for a term of years not to exceed 20 or for the life or lives of the individual beneficiaries. Following the non-charitable term the remaining trust assets are transferred to or held for the use of charity. Like the charitable remainder unitrust, when the charitable remainder annuity trust was created, the actuarial value of the remainder interest must be at least 10 percent of the net fair market value.

Charitable lead unitrusts pay a fixed percentage of the net fair market value of the trust assets valued annually to one or more charitable organizations for a term of years or for the life or lives of one or more individuals. Following the charitable lead term the assets pass to one or more individuals.

Charitable lead annuity trusts pay a fixed dollar amount usually expressed as a percentage of the initial fair market value of the property placed in trust to one or more charitable organizations for a term of years or for the life or lives of one or more individuals. Following the charitable lead term the assets pass to one or more individuals.

Pooled income funds are offered by established charitable organizations with set terms and qualification of the fund is not a part of securing the charitable deduction.

The preparer may list on Schedule O both inter vivos split interests created by decedent and under which the decedent retained an interest as well as split interests established by the decedent in the will or other testamentary documents.

[2] Real property not in trust

A gift of a remainder in certain real property may also qualify for the charitable contribution deduction.

[a] Personal residences

A gift of a remainder interest in a personal residence to a charitable organization with the interest for life passing to a non-charitable beneficiary will qualify for the charitable deduction. The residence must have been a personal residence of the decedent but it need not be the decedent's primary residence. For example, a remainder in a vacation home will comply. Treas. Reg. §20.2055-2(e)(2)(ii).

[b] Farms

A gift of a remainder interest in a farm to a charitable organization will qualify for the charitable deduction.

> [T]he term "farm" means any land [or its improvements] used by the decedent or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry.

Treas. Reg. §20.2055-2(e)(2)(iii).

[3] Reformation

Under certain limited circumstances, a split interest that does not qualify for deduction may be reformed to so qualify. IRC § 2055(e)(3). Reformation is discussed below.

[4] Death of non-charitable income beneficiary

If the non-charitable income beneficiary dies before filing the estate tax return, the split interest trust will be treated as automatically reformed to meet the requirements of a valid charitable trust. IRC § 2055(e)(3)(F).

For a case where the non-charitable beneficiary survived the decedent and received distributions prior to his death before the estate tax return was filed, and the court held that IRC § 2055(e)(3)(F) reformed the interest, *see, Harbison v. U.S.,* 86 AFTR 2d Par. 2000-7135 (N.D. Ga 2000).

In PLR 200043051 a decedent created a trust for her own benefit for her life. Upon her death the remainder of the trust was to be held in trust with the income paid annually to a college for need based scholarships. Prior to death the trust agreement was amended to prohibit activities not permitted to be engaged in by private foundations. When the

decedent died the trust was included in her estate for estate tax purposes but an offsetting estate tax charitable deduction was allowed under IRC § 2055.

[5] In Terrorem clauses and split interests

In PLR 7942073 and PLR 7732011 the Service ruled that an *in-terrorem* clause results in failure of a charitable remainder trust to qualify for the estate tax charitable contribution deduction. Subsequent to these rulings, IRC Section 664 (f) was enacted, which some believe may be intended to overrule such rulings, yet the statute deals with "qualified contingencies" which means a provision of a trust that provides upon the happening of a contingency that the distributions will terminate not later than such payments would otherwise terminate. To your author, that does not describe what occurs when an *in terrorem* clause is invoked. To some, IRC § 664 (f) indeed overcomes these rulings.

[6] Art and copyrights

Under IRC § 2055(e)(4) a qualified contribution of a work of art may be made even though the copyright is not part of the transfer; the work of art and the copyright are treated as separate property. "Work of art" means any tangible personal property with respect to which there is a copyright under Federal law. A "qualified contribution" means any transfer of property to a qualified organization if the use of the property by the organization is related to the purposes or function constituting the basis for the organization's exemption, provided the qualified organization is not a private foundation (private operating foundation is all right).

§17.02 *Amount deductible*

The deduction is limited to the amount actually available for charitable uses. If any death tax is payable in whole or in part out of any testamentary transfer that would otherwise be allowed or as a charitable deduction, the amount deductible is reduced by the amount of the taxes. IRC § 2055(c). Instructions, p. 17. In an interrelated computation, the taxes are increased as the charitable deduction is decreased. See, IRS Pub. 904 "Interrelated Computations for Estate and Gift Taxes."

[A] Limitation

There is no limitation in terms of a percentage of the estate that may be deducted.

For non-resident aliens, the amount entitled to the charitable deduction is limited to property subject to the U.S. estate tax, according to *A. Silver Estate*, TC 45,186 (2002). In this case, the decedent, citizen-resident of Canada, made bequests of $312,842 to Canadian registered charities in his will. The gross estate in the United States was valued at $516,268 and the alternate valuation date and the value of the gross estate outside the United States was over $100 million. The estate claimed a charitable deduction of the full $312,840 on the decedent's Form 706-NA and the IRS sent a Notice of Deficiency limiting the charitable deduction to $1,615, which is the amount of the charitable bequest times a fraction, the denominator of which was the U.S. assets, and the denominator of which was the total assets. The estate argued that the bequest was deductible in full pursuant to Art. XXIVD of the Revised Protocol Amending the Convention With Respect to Taxes on Income and Capital (the Revised Protocol) between the United States and Canada. The court ruled that the Senate report accompanying the Revised Protocol made it clear that the bequest had to be made from property subject to the U.S. estate tax in order to obtain a deduction for transfer to a Canadian registered charity. In this case, the bequests were paid solely out of funds and property located outside the United States, which meant that the funds used to satisfy the bequests were not subject to estate tax in the U.S. Under IRC § 2106(a)(2)(D), the charitable deduction cannot exceed the value of the transfer property required to be included in the gross estate.

[B] Amount must be determinable

The amount passing to charity must be pursuant to the directions of the decedent and not the election by others including the executor. In TAM 200306002, the IRS ruled that the decedent's estate was not entitled to a charitable deduction for proceeds paid to a charity in settlement of a will contest because the charity did not have an enforceable right to any portion of the estate under state law. The decedent executed a will that established a residuary trust for the lifetime benefit of one of his sisters, with the remainder passing to the charity. Then, in the next 35 years, the decedent executed six wills and a codicil, none of which named the charity as a beneficiary. Following decedent's death, his nieces, nephews and the charity contested the probate of the will executed by the decedent nearest his death and a settlement was reached under which the charity received a portion of the proceeds. Examining the relevant state law concerning the execution, revocation and revival of wills, the IRS concluded that there was little possibility that a state court would have admitted the decedent's first will to probate, based upon the charity's virtual impossibility of establishing that the first will had not been revoked by the subsequent six wills and codicils. The IRS ruled that the charity did not have any recognizable, enforceable rights to any portion of the decedent's estate and was therefore not entitled to the IRC § 2055 charitable deduction. To your author, the deduction would more likely

have been obtained had the nieces, nephews and the charity had the first will admitted to probate.

PLR 200252077 is an example of where the amount passed outright to charity pursuant to a settlement agreement of a bona fide will contest and qualified for the estate tax charitable deduction. The IRS found that there was a bona fide conflict among the parties and the litigation was not collusive.

Cases that support the estate tax charitable deduction in such cases include *Flanagan v. U.S.*, 810 F.2D 930 (10th Cir. 1987); *Estate of Strock v. U.S.*, 655 F.Supp. 1334 (W.D. Pa. 1987); *Northern Trust Co. v. U.S.* 41 AFTR2d 78-1523 (N.D. Ill. 1977); Rev. Rul. 89-31, 1989-1 CB 277.

The amount passing to charity must be ascertainable. In *Estate of Marine v. Comm.*, 990 F.2d 136, 139-140 (4th Cir. 1993), the appeals court agreed with the tax court that the amount under the will was not presently ascertainable and not deductible where the residue was split between Princeton University and Johns Hopkins University and a codicil authorized decedent's personal representatives "to compensate persons who have contributed to my well-being or who have otherwise been helpful to me during my lifetime by allocating to each of them such items of tangible personal property, or by transferring securities, or by giving them cash, or any combination of tangible personal property, securities or cash, as my Personal Representatives determine is a fair bequest for services rendered." Each bequest was limited to 1% of decedent's gross estate, but the number of individual non-charitable bequests was unlimited. The entire charitable bequest could have been limited by the personal representatives, and so the charitable bequest was unascertainable and not deductible in any amount.

The bequest will not qualify for a deduction if there is more than a negligible possibility that the bequest will pass to a non-qualifying entity. Treas. Reg. §20.2055-2(b)(1). There must be a 95% probability that the bequest will pass to a qualifying charity before a deduction is permitted. Rev. Rul. 70-425, 1970-2 CB 151.

[C] Split interests

For split-interest trusts (or pooled income funds) the amount entered on the schedule and deductible is the amount treated as passing to charity, not the entire amount that passes to the trust (fund). Instructions, p. 17.

The IRS has issued publications on how to make the charitable deduction calculation. There are also estate planning and estate administration software programs that assist in making the calculation.

In *Estate of Melvin Atkinson v. Comm.*, 115 TC 26 (2000), the Tax Court held that an estate was not entitled to a charitable deduction for property passing to a trust intended to qualify as a charitable remainder annuity trust because the required annual distributions to the non-charitable beneficiaries were not made. The trust was also disqualified because it was necessary to invade the trust corpus to satisfy estate and death taxes arising from distributions to a secondary beneficiary. Split interest trusts must function according to the regulations to get the deduction. Reformation of the trust under IRC § 2055(e)(3) was not an available remedy because a qualified reformation is available only to address problems arising in the documentation of the trust.

If the bequest to charity is made pursuant to an agreement that a charitable gift annuity will be paid to designated persons, the decedent's estate should get a charitable deduction for the difference between the value of the bequest and the value of the charitable gift annuity. See, Rev. Rul. 80-281, 1980-2 CB 282, and PLR 200230018.

[D] Conservation easements

Under IRC § 2031(c)(9), the estate may claim a charitable contribution deduction for a qualifying conservation easement granted after the decedent's death. Instructions, p. 17.

[E] Reduction for interest

The Instructions state that if installment payment of estate tax is elected, and the interest is payable out of property transferred to charity, the charitable deduction must be reduced by an estimate of the maximum amount of interest that will be paid on the deferred tax. Instructions, p. 17.

[F] IRD included

To maximize the value of the charitable gift, the preparer will seek to avoid income tax on IRD by having the IRD received by the tax exempt organization.

As to decedent's vested, non-qualified stock options, of which the unexercised options were to be left to charity, the IRD would be recognized by the charity and not the estate. PLR 2000-12076.

[G] Expenses for charitable deduction

The situation present for the marital deduction in *Comm. v. Estate of Hubert*, 117 S.Ct. 1124, 1126-1127 (1997) has a charitable deduction aspect. The IRS has adopted amendments to Treas. Reg. §20.2055-3 relating to the effect of certain administration expenses on the valuation of property that qualifies for the charitable deduction. The final regulations are effective for estates of decedents dying on or after December 3, 1999, and they bifurcate estate expenses into estate transmission expenses and estate management expenses.

[1] Estate management expenses

Management expenses do not reduce the value of property for charitable deduction purposes and are expenses that would be incurred in investing, maintaining and preserving the estate property. The charitable gift is not reduced by estate administration expenses attributable to and paid from the charitable share unless those expenses are deducted on the estate tax return under IRC § 2053.

[2] Estate transmission expenses

Estate transmission expenses include any expense that would not have been incurred but for the decedent's death and include any administration expense that is not a management expense. Estate transmission expenses include any administration expense that is not an estate management expense. Examples include probate fees, expenses incurred in construction proceedings and defending against will contests and appraisal fees, as well as most executor's commissions and attorney's fees.

[3] Unrestricted estate management expenses

The charitable deduction is reduced by the amount of any estate management expenses paid from the charitable share but attributable to a property interest not included in the marital share. Treas. Reg. §20.2055-3(b)(4).

[4] Estate management expenses deducted on Form 706

The charitable deduction must be reduced by the amount of any estate management expenses deducted under IRC § 2053 on the Form 706. Treas. Reg. §2055-3(b)(3). See the discussion above on the corresponding marital deduction regulation.

§17.03 *Reformation of split interest*[4]

Where a split interest is not in a form that meets the requirements of IRC § 2055(e)(2), and would not be deductible for estate tax purposes, the deduction can still be secured if there is a "qualified reformation" under IRC § 2055(e)(3). Reformations will be of testamentary split interests, not inter vivos ones.

[A] Qualified reformation defined

A qualified reformation means a change of a governing instruments by reformation, amendment, construction, or otherwise that changes a reformable interest into a qualified interest, subject to these limitations.

[1] Actuarial value limit

Any difference between (i) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and (ii) the actuarial value (as so determined) of the reformable interest, does not exceed 5 percent of the actuarial value of the reformable interest. Further, the charitable deduction is limited by IRC § 2055(e)(3)(E), which provides that the deduction allowed under IRC § 2055(a) with respect to the qualified reformation shall not exceed the amount of the deduction that would have been allowable for the reformable interest but for IRC § 2055(e)(2).

[2] Same termination or period

The charitable interest must terminate at the same time or be for the same period both before and after the qualified reformation. A nonremainder (income) interest before reformation for a term of years in excess of 20 years shall be treated as satisfying the requirement of termination at the same time, if such interest after reformation is for a term of 20 years.

[3] Effective date

The change must be effective as of the date of the decedent's death.

[B] Reformable interest defined

A reformable interest means any interest for which a deduction would be allowed at the time of the decedent's death, but for the fact that it does not meet the requirements of a charitable remainder unitrust, a charitable remainder annuity trust, or a pooled income fund. The statute also defines a reformable interest as limited to where the beneficiary's interest is fixed, but that rule is actually a time limit rule.

[C] Examples of reformable interests

These examples illustrate non-deductible charitable interests that are reformable interests:

> Example 1: A testamentary trust provides that all of the trust income will be paid to individual A for life with remainder to a charity. This is a non-deductible interest, because the income interest is not stated as a unitrust or annuity amount. Qualified reformation can change the income interest into a unitrust interest or annuity amount that insures that the remainder interest is at least 10% and that the remainder interest is within 5% of the value of the income interest.
>
> Example 2: A testamentary trust provides that individual A receives an annuity payment for 25 years with remainder to a charity. This is a non-deductible interest, because A's interest exceeds 20 years. Qualified reformation can change the income term to 20 years.
>
> Example 3: A testamentary trust provides that an annuity be paid to individual A for life with

[4] Much of this discussion and the examples are taken from Gary V. Post, "The Estate Tax Return: Challenges, Traps and Opportunities," Texas Society of CPA's 2001 Advanced Estate Planning Conference. [used with permission]

remainder to a charity, and the actuarial value of the remainder interest is less than ten percent (10%) of the value of the assets passing to the trust. This is a non-deductible interest, because the charitable remainder is less than ten percent. Qualified reformation can insure that the charitable remainder is at least ten percent by adjusting the payout rate or the duration.

[D] Examples of non-reformable interests

Some interests cannot be reformed into qualified reformations.

Example 4: A testamentary trust provides that a unitrust amount be paid to individual A for life, then to individual B for 20 years with remainder to charity. This is non-reformable because (i) the nonremainder interest is not for a term of years and (ii) any reformation would have to result in a different ending date. PLR200122045. Although non-reformable, it can be converted into a deductible interest if B would disclaim the right to any unitrust amounts receivable by his estate after his death.

Example 5: A testamentary trust provides that all of trust income will be paid to individual A for life and that additional distributions may be paid to A in the trustee's discretion as necessary for her comfort and happiness. This is non-reformable because the residual amount cannot be determined actuarially. If A disclaims the right to receive distributions for her comfort and happiness, the resulting trust provisions will then be in the form of a reformable interest identical to Example 1.

Example 6: Same facts as in Example 5, except that no discretionary amount may be paid to A, but A is given a special power of appointment which may be exercised in favor of noncharitable beneficiaries. This is a non-reformable interest because the residual amount cannot be determined actuarially. But A could disclaim the special power of appointment or disclaim the right to appoint to any person not described in IRC § 2055(a) and 170(c).

[E] Time limits

[1] Reformable interests

For a reformable interest to be a qualified reformation, a judicial proceeding must be commenced to change the interest into a qualified interest not later than the ninetieth day after the last date the estate tax return is due (including extensions) or if no estate tax return is required to be filed the last date for filing the income tax return for the first taxable year for which such return is required to be filed by the trust (including extensions).

[2] Non-reformable interests

The disclaimer cure must be recognized with sufficient time for the appropriate disclaimer to be prepared, signed, and filed within 9 months of the date of death.

The Texas disclaimer statute, TEX. PROB. CODE §37A, imposes the nine month disclaimer deadline on charitable organizations, not from the decedent's date of death but rather from receipt of the required notice, which occasionally is not properly given. Charitable organizations have an unlimited time in which to make a disclaimer if the notice is not sent by a Texas estate. Other state's laws may be similar.

[3] Technical defects in form

A technical defect in form, where the noncharitable interest is originally expressed as a specific dollar amount or a fixed percentage of the fair market value of the property, may be fixed at any time by a change of the governing interest by reformation, amendment, construction or other valid method under state law.

[F] Private letter rulings

Because the charitable deduction will be lost if the reformation is not a qualified reformation, the careful preparer should consider a private letter ruling request that the reformation as proposed will be qualified where there is any doubt as to whether the reformation meets the actuarial amount limit or the same termination or period limit. PLR 199936010, PLR 200105059, PLR 200201026, PLR 200227015 and 200425027, were all successful rulings for the estate. PLR 200414011 was not successful for the estate.

PLR 200402012 shows a creative solution where gifts to individuals and then to charity included both reformable and non-reformable interests. The executor made all distributions that were to occur upon death and then divided and distributed the remaining into two reformed trusts. The terms of Reformed Trust 1 contained those distributions to individuals with remainder to charity that could qualify as a charitable remainder trust. Reformed Trust 2 contained all other distributions with remainder to charity that could not be reformed into a charitable remainder trust. The IRS ruled that the proposed reformation of Reformed Trust 1 was a qualified reformation and the estate was entitled to a charitable deduction for the value of the charitable remainder. No charitable deduction was sought for the non-reformable interests that were isolated into Reformed Trust 2.

In PLR 200428013 reformation of a testamentary trust to create a charitable remainder annuity trust and reformation of a gift of a personal residence provides the estate tax charitable deduction for the present value of remainder interests in the trust and in the personal residence.

The decedent's will provided that the residue of his estate was to be held in a charitable trust. The will requires the trustees to lease free of charge decedent's personal residence and curtilage to decedent's spouse for her lifetime. During her life the spouse was to receive distributions of marketable securities and cash at least quarterly to enable her to live according to her station in life and in the manner to which she had been accustomed. The estate began a judicial proceeding to reform the trust under IRC § 2055(e)(3) and divide the trust assets into three parts. First, decedent's real property, except for the personal residence and curtilage, would be transferred to a newly created private foundation. Second, the personal residence and curtilage will be removed from the trust, and the spouse will receive a legal life estate in the personal residence and curtilage with remainder interest going to the foundation. Third, the marketable securities and cash would fund a charitable remainder annuity trust that will pay the spouse an annuity in quarterly installments equal to a percent of the initial net fair market value of the trust for her lifetime with the remainder to go to the foundation. The IRS ruled that an estate tax charitable deduction was allowed for the present value of the remainder interest in the charitable remainder annuity trust, the present value of the remainder interest in the personal residence, and the value of the real property used to fund the foundation. The Service also ruled that the value of the annuity interest passing to the spouse will qualify for the estate tax marital deduction.

[G] Reformation statute inapplicable

In preparing Schedule O make every effort to save a charitable deduction on a split interest by a reformation, even if you do not think it is applicable. In *Atkinson v. Comm.*, 01-16536 (11th Cir. 2002), at issue was a properly drafted charitable remainder annuity trust that was funded but never implement or followed. No annuity payments were made to the grantor during her life. There were several potential income beneficiaries with a remainder to qualified exempt charities and the estate argued that since the all but one of the non-charitable beneficiaries did not make the required payment of estate taxes and thus did not receive their income interest that the trust in effect transferred the corpus directly to the charities. The Eleventh Circuit determined that since the trustee made no attempt to comply with the regulations the entire trust was invalid, but in a footnote the court stated that it was not ruling on whether the CRAT could have been reformed under IRS Section 2055(e). Reformation would not have corrected the instrument because it was properly drafted, but reformation possibly could have been used to change the split interest into a direct bequest or to "reform" the administration.

PLR 200425027 is an instance in which a scribner's error was corrected in a reformation preceding in order to qualify a gift for the estate tax charitable deduction without resort to the reformation statute. The decedent's will provided that the residue of the estate must be held by a Trust for the benefit of a Foundation described in IRC § 501(c)(3) and Section 2055. The will also required the Trust to distribute the principle to the Foundation with certain limitations upon the amount that could be distributed. The will further required the Foundation to hold the Trust distributions in a separate fund and directed the Foundation to distribute all amounts received from the Trust to educational and charitable institutions that qualify as charities under the Internal Revenue Code. The will required the Trust to hold its assets subject to the provisions of the Foundation. The decedent's attorney inadvertently failed to include appropriate language in the Trust to qualify for the estate tax charitable deduction and the executor of the decedent's estate petitioned the court to reform the Trust to provide the trustee must distribute its net income at least often as annually to the Foundation and also to state that the Foundation must qualify as a Section 501(c)(3) charity and be described in Internal Revenue Code Sections 170(c) (2) and 2055(a). The ruling discussed the choice of law rule of Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), and noted that the applicable state's supreme court stated that "[i]t is well settled in this state that the mistake of a scrivener in preparing a deed or other writing may be established by parol evidence, and the instrument reformed accordingly. However, the evidence required to reform a written instrument must be clear, precise, convincing, and of the most satisfactory character (citations omitted)." The Service noted that the decedent's charitable intention to benefit the Foundation was clear from the will and that the attorney's affidavit describes the scribner's error that frustrated the decedent's intent. The Service ruled that the decedent's estate will be allowed an estate tax charitable deduction for the value of the Trust as reformed.

[H] Calculating the charitable deduction

Because of the complexity of calculating the charitable deduction, it is best to use software to make the calculations. A few software programs are mentioned in Appendix D. If the preparer does not have ready access to a program that makes the calculation, contact the charitable recipient and its advancement office usually will happily prepare the calculations on the software they have available. The calculation is made using the IRC § 7520 rate in

effect for the month of the decedent's death. If the estate qualified to use the alternate valuation date, it appears that the preparer uses the 7520 rate for the month of the AVD, but there is no authority to which your author can point you.

§17.04 *Disclaimers*

Disclaimer of an intervening interest may save a non-deductible split interest gift or a disclaimer of an intervening interest may let the interest pass to a charitable organization.

[A] Disclaimer questions

Question 2 on Schedule O asks "Did any property pass to charity as the result of a qualified disclaimer?" If a "yes" answer is given, the form says to attach a copy of the written disclaimer required by IRC § 2518(b). The instructions state that the charitable deduction is allowed for amounts that are transferred to charitable organizations as a result of a qualified disclaimer. "To be a qualified disclaimer, a refusal to accept an interest in property must meet the conditions of Section 2518. These are explained in Regulations Sections 25.2518-1 through 25.2518-3." Instructions, p. 17.

[B] Qualified disclaimers

[1] General requirements

The general requirements for a qualified disclaimer are discussed in the section "Disclaimers," in Chapter 1, "General Matters."

[2] Non-acceptance of property

To be a qualified disclaimer, the disclaimant must not have accepted the property or any of its benefits. When a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by the disclaimant in the exercise of fiduciary powers to preserve or maintain the disclaimed property are not treated as an acceptance of the property or its benefits, but a disclaimant cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed property. Unless special precautions are taken, a disclaimer that passes property to a private foundation of which the disclaimant is a fiduciary, may not be qualified and the contribution deduction is not available. PLR 199929027.

[C] Split interests

Split interests may not qualify as a charitable remainder trust, charitable lead trust, or pooled income fund, and disclaimer may remove the unqualifying split interest.

In PLR 8146038, the decedent left rental apartments to a trust, with the surviving spouse having the right to reside in the apartment and manage the project with remainder to charity. This was a non-qualified split interest and disclaimer by the surviving spouse qualified the bequest for a charitable deduction.

200234038	9827010	9549016
20022031	9529042	9349010
200006052	9716019	9527040
99903019	9633004	9349010
9852034	9610005	9341003
		9347013

Your author is familiar with an estate in which the decedent asked that the contents of his home be sold and given to his private foundation, but the decedent's significant other was permitted to use the contents for one year after death. The significant other disclaimed this right and the contents qualified for a charitable deduction. No private letter ruling was sought.

[D] Intervening interests

Where a charitable organization takes in default of a gift to a non-charitable beneficiary, a disclaimer can result in a charitable deduction.

In PLR 9113004, decedent bequeathed his art collection to his son with the provision that a portion of any disclaimed artwork would pass to a museum. The son disclaimed and a charitable deduction was allowed for the portion passing to the museum.

In PLR 200052006, the decedent's sister disclaimed interest in IRAs, an annuity contract and a trust with the result that the benefits passed to a foundation as secondary beneficiary.

[E] Right of recovery

In PLR 200127007, beneficiaries of a marital trust established under the predeceased spouse's will had an IRC § 2207A right of recovery under the tax clause of the surviving spouse's will. Their disclaimer of the right of recovery increased the amount of property passing to a residuary charitable beneficiary.

[F] To qualify for reformation

In PLR 9004011, the trustee was directed to pay trust income in equal shares annually to four individuals and to the survivor. Also, the trustee could invade principal for the care and maintenance of the beneficiaries. Upon the death of the survivor, 75% passed to four named charities and 25% to an individual. The beneficiaries disclaimed the right to receive discretionary invasions of principal and the estate was able to reform the trust into a charitable remainder annuity trust, holding 75% of the property.

[G] To remove non-charitable interests

In TAM 9123023, one beneficiary disclaimed the right to receive discretionary invasions of principal and another beneficiary disclaimed a

contingent remainder interest. Similar results occurred in these PLRs:

In PLR 8626046 the children gave up the power to select alternate charities if the named charity did not qualify under IRC § 2055 and their disclaimer increased the amount passing to a residuary charitable trust.

In PLR 9008011, the disclaimed property was destined for a private foundation of which the disclaimant was a director, and the disclaimant gave up the position.

[H] Avoiding retained power to direct disposition

For a disclaimer to be a qualified disclaimer, the disclaimant must not retain any power to direct the disposition of the disclaimed property. If the disclaimant can direct how the charitable organization distributes the property, then there is no qualified disclaimer.

In several private letter rulings, the disclaimant was prevented from directing the use of the disclaimed property by segregation of the disclaimed property to a separate account over which the disclaimant had no control or by amendments to the organizational documents of the foundation.

200127007	199903019	9323043
199944038	9823043	9320008
199929027	9350033	

The IRS has permitted the disclaimant's spouse or other relatives to have discretion over disclaimed property. PLRs 9350032, 9319022, 9235022, 9008011.

§17.05 *Court actions*

[A] Declaratory judgment

When the charitable organization designation is ambiguous, a declaratory judgment proceeding may be necessary to determine the decedent's intent as to the recipient. If a possible recipient is non-charitable, then the charitable deduction possibly may be unavailable and these actions may remain unresolved until well after the extended deadline for filing the tax return has come and gone. When the will makes a gift to "the Methodist Church in Brighton" and there are actually three Methodist Churches in Brighton, there is usually no question that the gift will ultimately pass to an IRC § 2055 organization and qualify for the charitable deduction. The same is true where questions arise regarding whether the recipient is the local chapter or the national office of a national organization. But if the gift is to "the Cowboy Museum in Bexar County" and there is a cowboy museum operated by a social club and a non-profit cowboy museum competing for the bequest, then the charitable deduction is uncertain. Uncertainty also arises when the gift is to a non-existing charitable organization or the organization refuses the gift.

In such events, there may be a court proceeding to determine if the decedent had a specific charitable intent or a general charitable intent. A finding of a general charitable intent means that the gift goes to a charitable organization similar to the organization that no longer exists or that refuses the gift. For example, a gift to "Ambassador College," which no longer exists, may go to another small college if the decedent had a general charitable intent. But when the decedent is found to have a specific charitable intent, then the gift fails and passes to the residuary if it was a specific or general gift, but when the gift is of the residuary, the gift may go by intestacy to the decedent's family. Do charitable organizations refuse gifts? Sometimes, when the gift is real property with environmental problems, or if the organization has policies against accepting large bequests, such as Alcoholics Anonymous. Early inquiries to the charitable organization may save surprises later when the estate is distributed.

[B] Interpretation or contest

Questions 1a and 1b on Schedule O request a "yes" or "no" answer to two questions regarding interpretation lawsuits or will contests.

> 1a. "If the transfer was made by will, has any action been instituted to have interpreted or to contest the will or any of its provisions affecting the charitable deductions claims in this schedule?"
>
> 1b. "According to the information and belief of the person or persons filing this return, is any such action planned?"

The form says that if a "yes" answer is given, full details must be submitted with the schedule, and the statement must be sworn. Treas. Reg. §20.2055-1(c)(2).

[C] Avoiding prohibited transactions

When a private foundation is a charitable beneficiary of the estate, distribution of the estate may result in indirect self-dealing. IRC § 4941(a) imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person and a private foundation as well as on foundation managers for agreeing to an act of self-dealing. IRC § 4941(d)(1) defines self-dealing as including any direct or indirect

> (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;
>
> (B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation;

Under IRC § 4946(a)(1) "disqualified persons" with regard to a private foundation includes a substantial contributor, a foundation manager, a family member of an individual described above, and a trust or estate in which persons described above hold more an 35% of the beneficial interest. Distribution of an estate under which a private foundation is to receive a portion of the residuary funded other than with an undivided interest in each asset can be self-dealing.

Fortunately, Treas. Reg. §53.4941(d)-1(b)(3) provides that "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vest under local law, if

(i) The administrator or executor of an estate or trustee of a revocable trust either –

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for federal income tax purposes pursuant to section 1.641(b)-3(a) (or in the case of a revocable trust, before it is considered subject to section 4947 of the Code);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either B

(a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(c) Is required under the terms of any option which is binding on the estate (or trust).

Possible self-dealing should not directly effect the amount reported on Schedule O, but the preparer may want to deduct on Schedule J the estimated cost of obtaining probate court approval.

PLR 200225037 is an example of a private letter ruling finding no improper self-dealing where GST taxes were approved by the probate court to come from the residuary passing to a private foundation.

PLRs 200219036 and 200219039 ruled that a private foundation's consent to a settlement agreement between an estate in which the foundation had an interest and the director of the foundation will not result in indirect self-dealing or loss of the foundation's exemption.

[D] Family settlement agreements

Rev. Rul. 89-31, 1989 CB 277, provides:

If in settlement of a bona fide will contest, a decedent's estate makes an immediate payment to a qualifying charity in satisfaction of the charity's claim to a split interest remainder that would not be deductible under section 2055(e)(2)(A) of the Code, the estate is entitled to a charitable deduction under section 2055.

In PLR 200227044 the IRS ruled that a private foundation's consent to a family settlement agreement would not be a prohibited act of self-dealing, where property passed under the decedent's estate plan to the spouse and then to the foundation, but did not acknowledge an enforceable agreement made during life to bequeath the property to the decedent's child. The family settlement agreement enforced the agreement and the foundation did not receive the bequest.

§17.06 *Required information*

[A] Calculation of residue

If the value of the residue or part of the residue is being deducted as passing to charity, a copy of the computation showing how the value was determined, including any reduction for taxes, must be attached. Instructions, p. 17.

The Instructions require the following additional information:

1. A statement that shows the values of all specific and general legacies or devises for both charitable and noncharitable uses. For each legacy or devise, indicate the paragraph or section of the decedent's will or codicil that applies. (If legacies are

made to each member of a class (e.g., $1,000 to each of the decedent's employees), show only the number of each class and the total value of property they received.)

2. The date of birth of all life tenants or annuitants, the length of whose lives may affect the value of the interest passing to charity under the decedent's will.

3. A statement showing the value of all property that is included in the decedent's gross estate but does not pass under the will, such as transfers, jointly owned property that passed to the survivor on decedent's death, and insurance payable to specific beneficiaries.

4. Any other important information such as that relating to any claim, not arising under the will, to any part of the estate (e.g., a spouse claiming dower or courtesy, or similar rights). Instructions, p. 17.

[B] Certified copies

If the charitable transfer is by will, a certified copy of the order admitting the will to probate must be attached, along with a copy of the will. For charitable transfers made by any other written instrument, a certified copy of recorded instruments or a verified copy of unrecorded instruments must be attached. Instructions, p.17.

[C] Disclaimer instrument

If property passes to a charitable organization as a result of a qualified disclaimer a copy of the written disclaimer must be attached. Instructions, p.17; Form, Schedule O, p. 31. Disclaimers to obtain a charitable deduction are discussed below.

[D] Will contests

If there is an actual or contemplated will contest, the executor must submit a sworn statement detailing the aspects of the contest. Treas. Reg. §20.2055-1(c)(2).

18 SCHEDULE P - CREDIT FOR FOREIGN DEATH TAXES

§18.01 *When required*

Schedule P must be completed if a credit is claimed on line 18, of part 2, credit for foreign death taxes.

§18.02 *When permitted*

Generally, the credit for foreign death taxes is allowable only if the decedent was a citizen or resident of the United States. The requirements are set forth in the Instructions, p.18. The credit will be the lesser of the foreign tax attributable to the property or the U.S. tax attributable.

§18.03 *Required attachments*

A Form 706-CE, Certificate of Payment of Foreign Death Tax, must be attached to support any credit claimed

19 SCHEDULE Q - CREDIT FOR TAX ON PRIOR TRANSFERS

§19.01 *Generally*

A previously taxed property credit (PTP credit) IRC § 2013, applies toward payment of federal estate taxes if the decedent inherited property within the last 10 years from an estate and such property generated federal estate tax in the transferor's estate. An actual tracing of assets is not required. The property need not be included in the decedent's gross estate and the property need not be in existence at the death of the decedent. The full requirements are set forth in the Instructions, pp.18-19. The PTP credit is not permitted for state death taxes so the elimination of the state death tax credit in 2005 makes the PTP credit more valuable.

§19.02 *Percentage allowable*

The PTP credit is based on a graduated scale, depending on when the transferor predeceased the decedent, as follows:

Time exceeding	Not exceeding	Percentage allowable
	2 years	100%
2 years	4 years	80%
4 years	6 years	60%
6 years	8 years	40%
8 years	10 years	20%
10 years	-	0%

§19.03 *How calculated*[5]

The PTP credit is calculated as *the lesser of:*

i. an amount determined by multiplying the **federal estate tax** of the transferor's estate by a fraction, the numerator of which is the **net property transferred to the decedent** and the denominator of which is the **adjusted taxable estate** of the transferor; and

[5] Much of this discussion and the examples are taken from Gary V. Post, "The Estate Tax Return: Challenges, Traps and Opportunities," Texas Society of CPA's 2001 Advanced Estate Planning Conference.

ii. the amount of federal estate tax generated by inclusion in the decedent's estate of the **net property transferred to the decedent.**

[A] Federal estate tax

For purposes of the PTP credit calculation, the *federal estate tax* is the federal estate tax paid by the estate of the transferor, excluding inheritance taxes paid to a state, but including any PTP credit allowed the transferor's estate and any credit allowed for gift taxes paid on prior transfers.

[B] Net property transferred to the decedent

This is the value of the *property transferred to the decedent*, as such property is valued in determining the federal estate liability of the first spouse, less any debts, expenses and taxes chargeable to such property.

"Property" here includes any beneficial interest received, so the credit is allowed for annuities, life estates, and interests in a trust that may not be included in the decedent's federal gross estate, in addition to assets in which the decedent becomes the complete owner. A five and five withdrawal right would appear to include outstanding rights of withdrawal held by the decedent on the date of death and the rights that could have been exercised in the future had the decedent not died.

The value of an annuity, income interest, remainder interest, or reversionary interest is computed using tables under IRC § 7520. The tables may not be used if the decedent was "terminally ill" as of the date of death of the transferor. A person is considered "terminally ill" if the person has an incurable illness or other deteriorating physical condition and there is at least a 50% probability that the person will die within one year. Treas. Reg. §20.2013-4(a); Treas. Reg. §20.7520-3(b)(3). If the decedent has in fact died within one year of the transferor, consider obtaining from the attending physician a statement that tracks the IRC § 7520 language and attach it to the return to avoid questions from the IRS. The value of the decedent's interest depends upon the decedent's age, which is determined as the decedent's nearest birthday on the date of the transferor's death.

[C] Adjusted taxable estate

This is the taxable estate of the transferor, less any death taxes paid with respect to such estate. *Death taxes* include federal, state, and foreign estate taxes paid.

[D] Limitation

The PTP credit cannot exceed the amount by which (i) the federal estate tax payable on the decedent's estate (after deducting the unified credit, the state death tax credit, the credit for gift taxes on pre-1977 gifts, and the credit for foreign death taxes) without regard to the PTP credit, exceeds (ii) the estate tax computed after excluding the net property transferred to the decedent from the decedent's gross estate (with an extra adjustment if the estate claims a charitable deduction).

§19.04 *Examples*

We will calculate the PTP credit using an example with these given facts, which involve a husband and wife:

Example 1: Husband dies first in 2000, and his will directs $675,000 to a Family Trust and the remaining assets to a QTIP Trust. All of their property is community property with a value of $5,000,000. Wife dies one year later, but her death was not clearly imminent when H died. The executor of husband's estate files his estate tax return by the nine month due date, and elects QTIP marital deduction treatment for the QTIP trust, resulting in no estate tax in the Husband's estate. Because no estate tax is paid in Husband's estate, Wife's estate cannot claim a PTP credit when the estate taxes are paid by Wife's estate.

Wife's property	$2,500,000
QTIP trust	1,825,000
Total	$4,325,000
Total Tax at Wife's death	1,799,000

Example 2: Basically the same facts as in Example 1, except Husband's executor files an extension to file Husband's estate tax return, and when Wife dies while Husband's return was on extension, the executor chooses not to elect QTIP marital deduction treatment for the QTIP Trust and pays taxes in Husband's estate.

Husband's gross estate	$2,500,000
Marital deduction	- 0
Husband's taxable estate	$2,500,000
Gross estate tax	$1,025,800
Unified credit	(220,550)
State death tax credit	(138,800)
Husband's net federal estate tax	$ 666,450

Assuming that Husband's will charges the estate tax entirely to the QTIP portion, the Family Trust will be funded with $675,000 and the QTIP Trust will be funded as follows:

Husband's gross estate	$2,500,000
Family Trust	(675,000)
Federal estate tax	(666,450)
State death tax	(138,800)
QTIP Trust	$1,019,750

Because Husband's assets pass to a non-elected QTIP Trust that provides for mandatory income payments to Wife, Wife's estate will qualify for a PTP credit. Wife's income interest in the QTIP Trust is calculated under IRC § 7520 as follows:

For purposes of this example, assume that Wife was 76 years old and was not terminally ill when Husband died. Further, assume that the IRC § 7520 rate at Husband's death was 7.8%. Finally, assume that Wife dies one year later at age 77 in September of 2001. Wife's income interest in the QTIP Trust is calculated under IRC § 7520 as follows:

Table S remainder factor for 76 year old	0.50846
Wife's life income interest (1.0-0.50846)	0.49154
Value of QTIP Trust at Husband's Date of Death	$1,019,750
Wife's property value for PTP computations: $1,019,750 x 0.49154 = $501,248	

The calculation of the PTP credit comes from the following formula:

$$\frac{\text{Net Property Transfer to Wife}}{\text{Adjusted Taxable Tax of Husband}} \times \text{Federal Estate Estate of Husband}$$

= PTP Credit

Assuming that the value of the Net Property Transferred to Wife was $500,000, the calculation of the PTP Credit is as follows:

$$\frac{\$\ 500{,}000}{\$1{,}694{,}750} \times \$666{,}450 = \$196{,}620$$

The PTP credit cannot exceed the amount by which (i) the federal estate tax payable on the Wife's estate (after deducting the unified credit, the state death tax credit, the credit for gift taxes on pre-1977 gifts, and the credit for foreign death taxes) without regard to the PTP credit, exceeds (ii) the estate tax computed after excluding the net property transferred to the Wife from the Wife's gross estate (with an extra adjustment if the estate claims a charitable deduction).

	(i) Estate tax (w/out excluded property)	(ii) Estate tax
Wife's gross estate	$2,500,000	$2,500,000
Excludible property	0	500,000
Taxable estate	$2,500,000	$2,000,000
Wife gross estate tax	$1,025,800	$ 780,800
Unified credit	(220,550)	(220,550)
State death tax credit	(138,800)	(99,600)
Federal estate tax payable	$666,450	$ 460,650
	$666,450	
	(460,650)	
Limitation	$205,800	

The PTP credit is the lesser of $196,620 and $205,800, or $196,620 in this case.

With a full QTIP marital deduction election in Husband's estate, the estate tax paid in Wife's estate was $1,799,000. With no QTIP marital deduction election in Husband's estate, and the PTP credit used in Wife's estate, the total taxes paid is as follows:

Husband's net federal estate tax	$ 666,450
Husband's state death tax credit	138,800
Wife's federal estate tax (before credit)	666,450
Wife's state death tax	138,800
PTP Credit	(196,620)
Total estate tax with PTP credit	$1,413,880

Tax with no PTP credit	$1,799,000
Tax with PTP credit	(1,413,880)
Tax savings	$385,120

Example 3: Decedent is single and he dies with an estate of $5,000,000. Decedent's uncle died seven years prior to decedent and gave decedent a vacation home worth $100,000 in Uncle's estate and now worth

$400,000. When Uncle died he had an estate of $2,500,000 and his estate paid estate tax of $694,200. The credit available to Decedent is as follows:

Uncle's Estate Assume death occurred in 1994 Current Year 2001 Estate $2,500,000		
Total Gross Estate Tax	$1,025,800	
Unified Credit	(192,800)	
State Death Tax Credit	(138,800)	
Net Federal Estate Tax Due	$ 694,200	
Decedent's Estate Year of Death--2001 Estate $5,000,000		
Total Gross Estate Tax	$2,390,800	
Unified Credit	(220,550)	
State Death Tax Credit	(391,600)	
PTP Credit on Vacation Home	(16,657)	(FN1)
Net Federal Estate Tax Due	$1,761,993	
(FNI) Value of Vacation Home* $100,000 x $694,200 = $1,667,000	$41,643.67 40.00%**	
Uncle's Adjusted Taxable Estate	$16,657.47	

Prior Tax Credit

* This value assumes that no taxes were charged to the Vacation Home

** Credit percentage established under IRC § 2013(a) for a prior transferor dying within the seventh or eight years preceding the decedent's death

§19.05 *Simultaneous death*

The tax court has ruled that the estates of a couple that boarded their private plane and disappeared are not entitled to tax on prior transfers credits and the value of the spouses' interests in each other's estates was valued at zero. *Estate of Harrison v. Comm.*, 115 TC 161 (2000). Simultaneous death cases will provide no situation for claiming the credit.

§19.06 *Disclaimers*

A disclaimer, which creates a presumed simultaneous death, has nevertheless been used to obtain a PTP credit. In TAM 8512004 the maximum marital deduction amount went to the decedent's surviving spouse. The residue was to pass to a trust that required that the income be paid quarterly to the surviving spouse. The surviving spouse died three months after the decedent and her estate renounced the marital bequest. The IRS permitted a PTP credit.

§19.07 *Planning*

The planning for obtaining the PTP credit is made when preparing the transferor's Form 706, not the Form 706 in which the credit is actually taken. If there is a question as to whether the surviving spouse will qualify for the credit, because of death within one year of the transferor, consider making the QTIP election under a formula that takes into consideration the anticipated credit.

Before filing the return, run the numbers both taking the PTP credit and not taking the credit to determine the savings that are available. With the scheduled repeal of the estate tax, deferral of the estate tax may be the wiser choice if the deaths do not occur within 15 months of each other.

§19.08 *Additional information*

Weinberg, *Prior Transfer May Yield Present Tax Benefit via a Credit*, ESTATE PLANNING, Jan.-Feb. 1995 at 10.

20 SCHEDULE R - GENERATION-SKIPPING TRANSFER TAX

§20.01 *The task at hand*

If individual schedules were to be graded, Schedule R is probably the schedule on which the lowest score would be earned. (This observation is stated with caution because you, the reader, may give your author the lowest score for this chapter.) The instructions contribute to this inadequacy in preparation by stating that Schedule R is used to calculate the GST tax paid by the estate if there are any "direct skips" occurring at death - failing to mention until much later in the instructions that Schedule R also is used to allocate the unused GST exclusion. The confusion is compounded because GST tax may be due on Schedule R and Schedule R-1.

§20.02 *GST tax repeal*

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA 2001") repeals the GST tax effective for generation-

skipping transfers and the estates of decedents dying after December 31, 2009. The GST tax will have the distinction of being the most short-lived of the three major transfer taxes.

§20.03 *When tax is due*

The GST tax is imposed only on property interests included in the gross estate, and only on "direct skips occurring at death," so computing the GST tax is a multi-step process.

[A] Steps to completion

These steps are the authour's; not the Service's in the Instructions.

Step 1. Identify grandfathered trusts. Determine whether a trust that otherwise would be subject to the GST tax is not because the trust pre-dates the effective dates of the GST tax.

Step 2. Determine available exemption.

Step 3. Complete asset schedules. Determine the property interests includable in the gross estate by completing Schedules A through I of Form 706. Preparation of Schedules R and R-1 come toward the end of completing the Form 706.

Step 4. Assign transferees to a generation. Determine who the skip persons are by assigning each transferee to a generation and determine whether each transferee is a "natural person" or a "trust" for GST purposes.

Step 5. Identify skip person transferees of interests in property. Determine which skip persons are transferees of "interests in property." When the skip person is a natural person, anything transferred is an interest in property, but when the skip person is a trust, additional rules, discussed below, must be followed.

Step 6. Choose Schedule R or R-1. Determine whether properly to enter the transfer on Schedule R or on Schedule R-1.

Step 7. Complete the appropriate schedule.

[B] direct skips?

Because the GST tax reported on Form 706 and Schedule R-1 is imposed only on direct skips, it is important to know what a direct skip is. A direct skip is a transfer that is:

1. Subject to the estate tax (Step 2);
2. To a skip person (Step 3); and
3. Of an interest in property (Step 4).

§20.04 *Step 1, Identify grandfathered trusts*

Determine whether a trust that otherwise would be subject to the GST tax is not because the trust predates the effective dates of the GST tax.

[A] Mental disability

In circumstances where the decedent was incompetent from October 22, 1986, until death and unable to change the disposition of his or her property, the transfers may be exempt from GST tax. LTR 200119031 sets forth an approved way of reporting the mental disability on Schedule R, and if a closing letter is given by the IRS, transfers from GST trusts are considered exempt. Because the mental disability must predate October 22, 1986, there will be fewer and fewer decedents who qualify for the effective date-incompetency exemption.

[B] Trusts not included in estate

[1] General rule

Any trust that was irrevocable on September 25, 1985, will not be subject to GST tax. Also, any transfer made under a revocable trust that became irrevocable by reason of the grantor's death after September 25, 1985, but before October 23, 1986. Treas. Reg. §26.2601-1(a)(4). Tax Reform Act of 1986, Section 1433.

[2] Powers of appointment

[a] General powers

Treas. Reg. §26.2601-1(b)(1)(v)(A) provides that where any portion of a trust remains in the trust after a post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust and that release, exercise, or lapse is treated to any extent as a taxable transfer under the estate tax or the gift tax statutes, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust. What this effectively means is that with a general power of appointment being exercised in a trust that was irrevocable on September 25, 1985, the grandfathering is lost and the transfer will be subject to GST tax. If the release, exercise, or lapse is of a power of appointment other than a general power of appointment, then the creator of the power will be considered to be the transferor of addition, which means that the grandfathering provisions will apply for such special powers of appointment.

In *Simpson v. U.S.*, 183 F.3d 812, 814-815 (8th Cir. 1999), rev'g 17 F. Supp. 2d 972 (W.D. Mo. 1998), it was held that a generation-skipping transfer made from a 1966 irrevocable trust by means of a general power of appointment is not subject to GST tax, even though the transfer occurred in 1993, because the exception set forth in the effective date provision under Section 1433(b)(2)(A) of the Tax Reform Act of 1986 applied to the transfer. The IRS has nonaquiesced in 2000 TNT 39-8. *Simpson* conflicts with *E. Norman Peterson Marital Trust v. Comm.*, 78 F.3d 795 (2nd Cir. 1996) but is in accord with *Bachler v. U.S.*, 9th Cir. 00-17239 (1 Mar 2002).

[b] Powers and perpetuities

The release, exercise, or lapse other than a general power of appointment will not be treated as an addition to a trust if (1) the power of appointment was created in an irrevocable trust not subject to GST tax because of the effective dates, and (2) in the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of the creation of the trust, extending beyond any life in being at the date of the creation of the trust plus a period of twenty-one (21) years plus, if necessary, a reasonable period of gestation. The exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest of property for a term of years that will not exceed ninety (90) years, measured from the date of creation of the trust, will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities. Further, if a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised. Treas. Reg. §26.2601-1(b)(1)(v)(B). If the power is exercised to suspend the vesting for the longer of lives in being plus twenty-one (21) years, or a term not more than ninety (90) years measured from the creation of the trust, such an exercise will be a constructive addition to the trust. Treas. Reg. §26.2601-1(b)(1)(v)(D), Example 6. Because of these detailed effective date rules, great care must be taken in the determination of whether the effective date rules apply where a special power of appointment in a grandfathered trust has been exercised by the decedent.

[c] Reformation to protect exempt trust

In PLR 200201017 a reformation petition was filed to correct a scrivener's error, consistent with applicable California law, to reform a son's general power of appointment on a GST exempt trust irrevocable prior to September 26, 1985, to a limited non-general power of appointment. The IRS ruled that the reformation would not subject the son's trust or distributions made from that trust to the GST tax. This ruling was sought while the son was alive and the ruling may have been different had the reformation petition been filed after the son's death. A related ruling is at PLR 200201020.

Reformation to correct a scrivener's error on distributions to children and grandchildren was ruled to not cause loss of the grandfathering, in PLR 200423006. Severance into five trusts and modification did not lose grandfathering in PLR 200409003.

PLR 200225029 approved a division of a grandfathered trust into two separate trust for the two children's families and gives an example of factors of equal treatment of beneficiaries. While division clearly will not lose grandfathering, the onerous level of tax makes seeking a private letter ruling the better part of wisdom. The rulings sought include PLRs 200428017 and 200426005-007.

§20.05 *Step 2, Determine available exclusion*

The available GST exclusion to be allocated depends upon the year of the decedent's death, see table, and the amount of GST exclusion allocated during the decedent's life to GST transfers. The allocation rules of IRC § 2632 will apply to decrease the GST exemption available to allocate on Schedule R. In PLR 200510026 substantial compliance doctrine applied to validate faulty allocation of GST exemption on a gift tax return. PLR 200511014 was the same.

Table 13
GST Exclusion
After EGTRAA 2001

Death in	Exclusion
2004	$1,500,000
2005	$1,500,000
2006	$2,000,000
2007	$2,000,000
2008	$2,000,000
2009	$3,500,000
2010	repeal
2011	?

§20.06 *Step 3, Complete asset schedules*

Determine the property interests includable in the gross estate by completing Schedules A through I of Form 706. Preparation of Schedules R and R-1 come toward the end of completing the Form 706.

[A] Values

The estate tax value is also its GST tax value, so if alternate valuation is elected or special use valuation is elected, those values must be used on Schedules R and R-1. In PLR 200448006 its special use value was used for allocation of the GST exemption.

[B] Schedule A to I assets

The property reportable on Schedules A through I should be subject to GST tax if there is a skip. But, see discussion above entitled "General powers," where some courts have ruled that general powers of appointment listed on Schedule H are not subject to the GST tax.

[C] ETIP assets

A trust subject to an estate tax inclusion period (ETIP), meaning the trust is includable in the gross estate of the transferor or spouse, may be allocated GST exemption on the date of termination of the ETIP. The ETIP termination date is the earlier of the death of the transferor or spouse or the date on which no portion of the property would be includable in the gross estate of the transferor or spouse. If the ETIP is terminated on death of the transferor, GST exemption may be allocated to the trust on the estate tax return.

§20.07 *Step 4, Assign transferees to a generation*

Determine who the skip persons are by assigning each transferee to a generation and determine whether each transferee is a "natural person" or a "trust" for GST purposes.

[A] Natural persons

A transferee who is a natural person is a skip person if that transferee is assigned to a generation that is two or more generations below the generation assignment of the decedent. Instruction, p. 20. Generations are determined as follows:

[1] Family members

Where the beneficiary is a lineal descendent of a grandparent of the decedent (e.g., the decedent's cousin, niece, nephew, etc.), the number of generations between the decedent and the beneficiary is determined by subtracting the number of generations between the grandparent and the decedent from the number of generations between the grandparent and the beneficiary. From the "Generation Allocation" diagram, a grand nephew is two or more generations below the decedent, as is a grandchild or a cousin twice removed. Descendants of higher ancestors, such as a great grandparent, are not considered.

Where the beneficiary is a lineal descendant of a grandparent of a spouse (or former spouse) of the decedent, the number of generations between the decedent and the beneficiary is determined by subtracting the number of generations between the grandparent and the spouse (or former spouse) from the number of generations between the grandparent and the beneficiary.

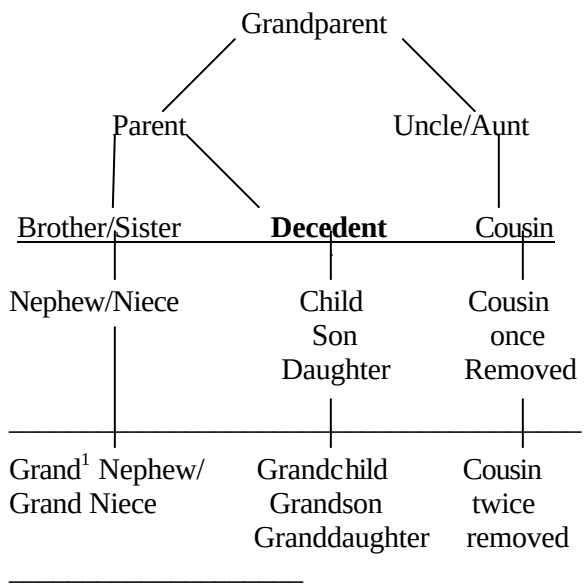
A person who at any time was married to a person described above is assigned to the generation of that person. A person who at any time was married to the decedent is assigned to the decedent's generation.

A relationship by adoption or half-blood is treated as a relationship by whole-blood. When generation assignment is based on adoption, the careful preparer will obtain confirmation of adoption by requesting copies of the adoption papers.

[2] Non-family members

A person not assigned to a generation under the family rules is assigned a generation based upon his or her birth date compared to the birth date of the decedent. A person who was born not more than 12 ½ years after the decedent is in the decedent's generation. A person born more than 12 ½ years, but

Generation Allocation



[1]These are also commonly referred to as a "Great Nephew" or a "Great Niece."
[2]This is not properly referred to as a "second cousin."

not more than 37 ½ years, after the decedent is in the first generation younger than the decedent.

A person more than 37 ½ years younger than the decedent is a skip person. A similar rule applies for a new generation every 25 years. Where a non-family member is a transferee, good practice is to request a copy of the transferee's birth certificate. Look forward to explaining to a transferee 37 ½ years younger than the decedent why he receives only 50% of the amount stated in the will.

[3] Deceased intervening parent

It seems inappropriate to tax as a GST transfer a gift made to a grandchild when the parent is not living, and the gift to the grandchild has no tax avoidance purpose. Thus we are given a special rule when the intervening parent is dead, IRC § 2651(e)(1).

If property is transferred to an individual [*e.g.*, grandchild, great nephew] who is a descendant of a parent of the transferor, and that individual's parent

(who is a lineal descendant of the parent of the transferor) [child, nephew] is dead at the time the transfer is subject to gift or estate tax, then for purposes of generation assignment, the individual [grandchild, great nephew] is treated as if he or she is a member of the generation that is one generation below the lower of:

- The transferor's generation, or
- the generation assignment of the youngest living ancestor of the individual, who is also a descendant of the parent of the transferor. Instructions, p.20.

If the transferor has any living lineal descendants, then this rule does not apply to a transfer to an individual who is not a lineal descendant of the transferor. In other words, it applies to collateral family members only if there are no direct descendants. Instructions, p. 20.

If any transfer of property to a trust would have been a direct skip except for this generation assignment rule, then the rule also applies to transfers from the trust attributable to such property. Instructions, p. 20.

The generation assignment for family members applies where the decedent and the beneficiary are both descendants of the grandparent of the decedent, but the move-up rule only applies where the deceased intervening parent of the beneficiary is a descendant of the decedent's parent. Thus, the move-up rule does not apply to first cousins.

[4] Proposed regulations

The Service on September 2, 2004, issued proposed rules, Reg. 145988-03, on assigning individuals to particular generations for purposes of the generation-skipping transfer tax in cases where a parent predeceases his or her offspring. The rules determine that the time when an interest in property or a trust is established or derived is the time the transferor is subject to transfer tax under Chapters 11 or 12 of the IRC. An exception is provided for remainder interests in trust for which an election under IRC § 2056(b)(7), where the remainder beneficiary's interest will have been deemed to have been established or derived on the death of the transferor's spouse rather than on the transferor's earlier death. The existing rule under IRC § 2651(e) does not apply to any trust for which a reverse QTIP election is made under IRC § 2652(a)(3). In most cases in which the reverse QTIP election has been made for a trust, the transferor's GST tax exemption has been allocated to the trust and that trust therefore will be exempt from tax. In another change, the proposed regulations limit the term "ancestor" to a lineal ancestor. The proposed rules also permit some flexibility in the adoption of minors and eligibility for beneficial tax treatment.

[B] Trusts and entities

For GST tax purposes, a trust includes not only an explicit trust but also any other arrangement (excluding an estate) which, although not explicitly a trust, has substantially the same effect as a trust. Examples include life estates with remainders, terms for years, and insurance and annuity contracts.

If an estate, trust, partnership, corporation, or other entity (except as set forth below) is a transferee, then each person who indirectly receives the property interests (discussed below) through the entity is treated as a transferee and is assigned to a generation as explained in the above rules. Instructions, p. 20. This does not apply to certain charitable organizations and trusts described in IRC § 511(a)(2) and 511(b)(2). Such trusts are assigned to the decedent's generation, and transfers to such organizations and trust are not subject to the GST tax. Instructions, p. 20. This look-through rule does not apply for the purpose of determining whether a transfer to a trust is a direct skip.

Transfers to or in the form of charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds are not considered made to skip persons and therefore, are not direct skips even if all of the life beneficiaries are skip persons.

Substantially separate and independent shares of different beneficiaries in a trust are treated as separate trusts. Instructions, p. 20.

[C] Skip persons and non-skip persons

After making the generation assignment as indicated above, and determined if a transferee received an interest in property, you are ready to determine who is a skip person and who is not.

A transferee who is a natural person is a *skip person* if that transferee is assigned to a generation that is two or more generations below the generation assignment of the decedent.

A transferee who is a trust is a skip person if all the interests in the property (discussed below) transferred to the trust are held by skip persons. Whenever a non-skip person has an interest in a trust, the trust will not be a skip person even though a skip person also has an interest in the trust.

A trust will also be a skip person if there are no interests in the property transferred to the trust held by any person, and future distributions or termination from the trust can be made only to skip persons.

A *non-skip person* is any transferee who is not a skip person.

§20.08 *Step 5, Identify skip persons transferees of interests in property*

Determine which skip persons are transferees of "interests in property." When the skip person is a natural person, anything transferred is an interest in property, but when the skip person is a trust, additional rules must be followed. A person will have an interest in the property transferred to a trust if that person either has a present right to receive income or corpus from the trust (such as an income interest for life) or is a permissible current recipient of income or corpus from the trust (*e.g.*, may receive income or corpus at the discretion of the trustee). Instructions, p. 20.

§20.09 *Step 6, Choose Schedule R or R-1*

Determine whether to enter the transfer on Schedule R or on Schedule R-1.

[A] General rule: Report on Schedule R

All generation skipping transfers are reported on Schedule R unless the rules below specifically provide that they are to be reported on Schedule R-1.

Under IRC § 2603(a)(2), the GST tax on direct skips from a trust is to be paid by the trustee and not by the estate. Schedule R-1 serves as a notification from the executor to the trustee that a GST tax in due, according to the instructions. Instructions, p. 20.

Direct skips made from a trust are reportable on Schedule R-1 if the trust must be includable in the decedent's gross estate, regardless of whether the recipient is a trust or an individual.

> Example: If the decedent was the surviving spouse life beneficiary of a marital deduction power of appointment (or QTIP) trust created by the decedent's spouse, then transfers caused by reason of the decedent's death from the trust to skip persons are direct skips required to be reported on Schedule R-1.
>
> Example: If property in a trust is included in the decedent's gross estate under IRC §s 2035, 2036, 2037, 2038, 2039, 2041, or 2042 and such property is, by reason of the decedent's death, transferred to skip persons, the transfers are direct skips required to be reported on Schedule R-1.

[B] Direct skips from explicit trusts

An explicit trust is a trust as defined in Treas. Reg. §301.7701-4(a) as "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." Direct skips from explicit trusts are required to be reported on Schedule R-1 regardless of their size, unless the executor is also a trustee.

[C] Executor as trustee

If any of the executors of the decedent's estate are trustees of the trust, then all direct skips with respect to that trust must be shown on Schedule R and not on Schedule R-1, even if they otherwise would have been required to be shown on Schedule R-1. Instructions, p. 21. This makes sense when we remember that Schedule R-1 is a notice to the trustee.

[D] Trusts other than explicit

Direct skips from trusts that are trusts for GST tax purposes but are not explicit trusts are to be shown on Schedule R-1 only if the total of all tentative maximum direct skips (direct skips minus any allocated GST exemption) from the trust is $250,000 or more. When this total is less than $250,000 the skips should be shown on Schedule R; but the executor has a right to recover any tax paid from the trustee or from the recipient of the property. Treas. Reg. §26.2662-1(c)(2).

> Example: A liquidating trust (such as a bankruptcy trust) under Treas. Reg. §301.7701-4(d) is not treated as an explicit trust for the purposes of this special rule.
>
> Example: Proceeds of a life insurance policy are includable in the gross estate and are payable to a beneficiary who is a skip person, the transfer is a direct skip from a trust that is not an explicit trust.
>
> Example: An annuity includable on Schedule I and its survivor benefits are payable to a beneficiary who is a skip person, then the transfer is a direct skip from a trust that is not an explicit trust.

In each example, if the total tentative maximum direct skips from the entity paying the annuity is $250,000 or more, the amount is reported on Schedule R-1, otherwise it is reported on Schedule R.

§20.10 *Step 7, Complete the appropriate schedule*

[A] Allocation of GST exemption

As mentioned earlier, Schedule R and R-1 are used to allocate unused GST exemption in addition to reporting GST tax. Any GST exemption not accounted for on this schedule will be allocated automatically and the allocation of GST exemption of a decedent is valid only if made on a return timely filed on the due date or with extensions.

[1] Typical allocation

In most estates, the GST exemption will be allocated to the credit shelter trust, since it is the most likely to be multi-generational.

[2] Marital deduction trusts

[a] Exemption wasted

The GST exemption allocated to a marital bequest that is outright, a power of appointment trust, or an estate trust, is wasted because the property will be included in the surviving spouse's gross estate and only the surviving spouse's exemption can be allocated.

[b] Certain QTIP elections

The surviving spouse will not be treated as the transferor of the property for GST tax purposes under IRC § 2652(a) where the QTIP election can be treated as null and void for purposes of IRC § 2044(a) when the election was not necessary to reduce the estate tax liability to zero on the pre-deceased spouse's estate, according to Rev. Proc. 2001-38; 2001-24 IRB 1335. The surviving spouse's estate must produce sufficient evidence that the election is within the scope of the revenue procedure, by providing a copy of the Form 706 filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero. This revenue procedure does not apply to (i) situations in which a partial QTIP election was required for a trust to reduce the estate tax liability and the executor made the election for more trust property than was necessary to reduce the estate tax liability to zero; (ii) elections that are stated in terms of a formula designed to reduce the estate tax to zero; or (iii) protective elections under Treas. Reg. §20.2056(v)-7(c).

[c] Reverse QTIP election

In the case of property for which a martial deduction is allowed to the decedent's estate under IRC § 2056(b)(7) (QTIP election), IRC § 2652(a)(3) allows the executor to treat such property for purposes of the GST tax as if the election to be treated as QTIP had not been made, the "reverse QTIP election." The IRC § 2652(a)(3) election must include the value of all property in the trust for which a QTIP election was allowed under IRC § 2056(b)(7) and cannot be partial. If an IRC § 2652(a)(2) election is made, then the decedent will for GST tax purposes be treated as the transferor of all the property in the trust for which a marital deduction was allowed to the decedent's estate under IRC § 2056(b)(7). In this case, the executor of the decedent's estate may allocate part or all of the decedent's GST exemption to the property. The significance of this occurs upon the death of the surviving spouse; the trust will be included in the survivor's estate for estate tax purposes, but the exemption allocated in the first decedent's estate will not be lost. As a result of EGTRRA 2001, in 2004, the estate tax applicable exclusion amount and the GST exclusion will be numerically equivalent, and there will be reduced need to utilize the "reverse QTIP election" under IRC § 2652(a)(3).

In Rev. Proc. 2004-47, 2004-32 IRB 169, the Service provided a simplified alternate method for obtaining relief to make a late reverse qualified terminable interest property election under IRC § 2652. Effective August 9, 2004, the alternate method may be used in lieu of the letter ruling process, if the requirements are met. Various rulings have granted an extension to make a reverse qualified terminable interest property election under the relief provisions of Treas. Reg. §301.9100-1 *et seq*.

200411004	200439036	200443025
200425029	200441022	200443027

[d] Division of trusts

A single QTIP trust may be divided into two trusts and the GST exemption then applied to one of the trusts. The split can be fractional or the assets must be allocated on a "fairly representative" test. Various rulings have approved variations on this theme. PLR 9122071, 9002014, 9050022, 9101013, and 9007016.

[B] Completing Schedule R

[1] Allocation of exemption

Part 1 -GST exemption reconciliation. Part 1, line 6 of both Parts 2 and 3, and line 4 of Schedule R-1 are used to allocate the decedent's GST exemption. This allocation is made by filing Form 706. Once made, the allocation is irrevocable, except that an allocation made on a second timely-filed return can supercede the first allocation if the second allocation clearly states that it supercedes the first. IRC § 2053. The portion of the exemption that you do not timely allocate will be allocated by the IRS under the deemed allocation at death rules of IRC § 2632(c). Allocation of GST exemption on a timely filed estate tax return is effective as of the date of death.

[2] Amount of exemption

The amount of the GST exemption is indexed to inflation for transfers made after 1998; Table 12, GST Exemption Year of Death, gives the GST exemption prior to EGTRRA 2001.

In EGTRRA 2001, the amount of the GST exemption was pegged to the applicable exclusion amount for federal estate tax during the phase-in of repeal, as shown in Table 13, GST Exclusion After EGTRAA 2001.

If repeal of the GST tax is repealed in 2011, the GST tax will be reinstated with an exemption that is inflation adjusted for $1,000,000 in 1997.

Table 12 GST Exemption Year of Death Pre EGTRRA 2001		
Death in	Exemption	Announced in
1998 or before	$1,000,000	
1999	$1,010,000	Rev.Proc. 98-61
2000	$1,030,000	Rev.Proc. 99-42
2001	$1,060,000	Rev.Proc. 2001-13
2002	$1,100,000	Rev.Proc. 2001-59
2003	$1,120,000	Rev.Proc. 2002-70

[3] Special QTIP election

You make this election simply by listing qualifying property on line 9 of Part 1. Completion of this line requires careful thought.

[4] Further completion of allocation

[a] *Part 1, Line 2*. Decedent's allocations

These allocations will have been made either on Forms 709 filed by the decedent or on Notices of Allocation made by the decedent for inter vivos transfers that were not direct skips but to which the decedent allocated the GST exemption. These allocations by the decedent are irrevocable.

[b] Void allocations

While allocations of GST exemption are irrevocable, all allocations made on Forms 709 must be reviewed to see if the allocation is void because the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation at the time of the allocation. Treas. Reg. §26.2632-1(b)(2)(i). In PLR 199948024, this regulation was applied to restore a transferor's GST exemption allocated to an inter vivos QTIP trust but as to which the reverse QTIP election had not been made.

[c] Substantial compliance

The converse of a void allocation is substantial compliance, which is found in PLR 200224018, in which three trust agreements attached to the federal estate tax return contained sufficient information to constitute substantial compliance with requirements for making timely allocation of the decedent's GST exemption. The ruling analyzes the specific distribution terms of each of the trusts. Only Trust Two addressed the allocation of decedent's GST exemption. It explicitly directed the trustee to divide the remaining trust assets into generation-skipping trusts and a non-exempt trust. In addition, it provided that the assets of the generation-skipping trusts be further divided into two separate sub-trusts with 60% being set aside in a trust for Child One and 40% being set aside in a trust for Child Two. The Service concluded that the trust agreements attached to the federal estate tax return contained sufficient information to constitute substantial compliance with the requirements for making a timely allocation of the decedent's GST exemption with respect to Trust Two.

[d] Extension of time to allocate

IRC § 2642(g)(1) authorizes the IRS to issue regulations under which extensions of time will be granted to make an allocation of the exemption to lifetime transfers under IRC § 2642(b)(1). In making a determination to grant an extension, the IRC is to take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer. IRC § 2642(g)(1)(B). Notice 2001-50, 2001-2 CB 189, provided details of procedure for requesting relief. Under Treas. Reg. §301.9100-3a relief from deadline will be granted if taxpayer proves that he acted reasonably and in good faith, and that grant of relief will not prejudice interests of the government. Estates seeking relief should follow procedures for requesting private letter ruling under Treas. Reg. §301.9100-3 reflected in sec. 5.02 of Rev. Proc. 2001-1, 2001-1 IRB 1.

Numerous private letter rulings have been issued granting an extension of time to allocate generation-skipping transfer tax exemptions. These are recent ones granted.

200407003	200409028	200419022
200407005	200410006	200419027
200409004	200411009	200422051
200409026	200414002	200427010
200409028	200419021	200411006

In Rev. Proc. 2004-46, 2004-31 IRB 142 the Service provides a simplified alternate method for obtaining an extension to make an allocation of the GST exemption under IRC § 2642(b)(1), effective August 2, 2004, that may be used in lieu of the letter ruling process.

[e] Automatic allocation to direct skips

Any direct skips made during decedent's life received automatic allocation of GST exemption, IRC § 2632(b), even if not properly reported on decedent's Form 709s, unless the decedent elected out of the automatic allocation under IRC § 2632(b).

In PLR 200201003 (and the related ruling for the taxpayer's wife at PLR 200201002), in years 1 and 2, the taxpayer and his wife transferred assets to trusts of which their grandchildren were the only beneficiaries and each filed gift tax returns splitting

the gifts. In years 3 and 4, taxpayer made transfers and both he and his wife filed gift tax returns splitting the gifts. Neither taxpayer allocated GST exemption to the gift nor paid any GST tax. The IRS ruled that both taxpayers' unused GST exemption was allocated automatically to the trust each time that a gift was made and that the wife's exemption was automatically allocated when she agreed to split gifts in years 3 and 4.

[f] Automatic allocation to indirect skips

Any indirect skips made after December 31, 2000, received automatic allocation of GST exemption, IRC § 2632(c), unless the decedent elected out of the automatic allocation under IRC § 2632(c)(5). The election out of the automatic allocation for indirect skips must be made on a timely filed gift tax return. Thus, for indirect skips made in the year of decedent's death and possibly prior periods, if a gift tax return has not been filed but it is still timely, the preparer of the Form 706 should consider whether to elect out of the GST allocation. If the value of the indirect skip has decreased from the date of the gift to the date of death, the preparer should consider electing out of the automatic allocation on the Form 709 and then allocate GST exemption at the lower amount on the Form 706.

On July 12, 2004, the Service issued proposed rules, Reg. 153841-02, for the election out of the automatic allocation rules for indirect skips and the election to treat any trust as a GST trust. Transferors who want to elect out of the allocation for indirect skips have two options: (1) they can elect out for the specific transfer to the GST trust and (2) make a single election with regard to the trust that applies to the current transfer and all subsequent transfers made by that transferor to the trust. Under the second option, one the election is made with regard to a trust, it remains effective for all subsequent transfers to that trust by the electing transferor until that transferor's election is terminated.

[g] Extension to elect out

The preparer of the Form 706 should consider whether to request under IRC § 2642(g)(1) an extension of time to make an election out under IRC § 2632(b)(3), automatic allocation to direct skips, or IRC § 2632(c)(5), automatic allocation to indirect skips. See Rev. Proc. 2001, Sec. 5.02, 2001-1 IRB 1.

Part 1, Line 3. Make an entry on this line if filing Form(s) 709 for the decedent and exemption will be allocated on those returns.

Part 1, Lines 4, 5, and 6. These lines represent allocation of the GST exemption to direct skips made by reason of the decedent's death. Complete Parts 2 and 3 and Schedule R-1 before completing these lines.

Part 1, Line 9. Line 9 is used to allocate the remaining unused GST exemption (from line 8) and to help you compute the trust's inclusion ratio. Line 9 is a Notice of Allocation for allocating the GST exemption to trusts as to which the decedent is the transferor and from which a generation-skipping transfer could occur after the decedent's death. If line 9 is not completed, the deemed allocation at death rules will apply to allocate the decedent's remaining unused GST exemption, first to property that is the subject of a direct skip occurring at the decedent's death, and then to trusts as to which the decedent is the transferor. To avoid the application of the deemed allocation rules, trusts to which part of the decedent's GST exemption is to be allocated are entered on line 9 (except certain trusts entered on Schedule R-1, as described below).

Say the credit shelter trust is to be funded with $1,000,000, for a decedent dying in 2002, but there are $60,000 of attorneys fees not deducted on the Form 706 and therefore paid out of the credit shelter trust. How much GST exemption do you allocate, $940,000 or $1,000,000? It seems to your author that you would allocate $940,000 under a formula that you are allocating enough so there is an inclusion ratio of zero.

Part 1, Line 9. If a trust is entered on Schedule R-1, the amount entered on line 4 of Schedule R-1 serves as a Notice of Allocation and it need not be entered on line 9 unless you wish to allocate more than the Schedule R-1, line 4 amount to the trust. However, you must enter the trust on line 9 if you wish to allocate any of the unused GST exemption amount to it. Such an additional allocation would not ordinarily be appropriate in the case of a trust entered on Schedule R-1 when the trust property passes outright (rather than to another trust) at the decedent's death. However, where IRC § 2032A property is involved it may be appropriate to allocate additional exemption amounts to the property. See the instructions for line 10.

Part 1, Line 9, column C. Enter the GST exemption included on lines 2 through 6 of Part 1 of Schedule R, and discussed above, that was allocated to the trust.

Part 1, Line 9, column D. Allocate the amount on line 8 of Part I of Schedule R in line 9, column D. This amount may be allocated to transfers into trusts that are not otherwise reported on Form 706. For example, the line 8 amount may be allocated to an inter vivos trust established by the decedent during his or her lifetime and not included in the gross estate. This allocation is made by identifying the trust on line 9 and making an allocation to it using

column D. If the trust is not included in the gross estate, value the trust as of the date of death. You should inform the trustee of each trust listed on line 9 of the total GST exemption you allocated to the trust. The trustee will need this information to compute the GST tax on future distributions and terminations.

This allocation may be pursuant to a formula such as the following, usually on a continuation sheet:

WORKSHEET (inclusion ratio for trust):

1	Total estate and gift tax value of all of the property interests that passed to the trust	_____
2	Estate taxes, state death taxes, and other charges actually recovered from the trust	_____
3	GST taxes imposed on direct skips to skip persons other than this trust and borne by the property transferred to this trust	_____
4	GST taxes actually recovered from this trust (from Schedule R, Part 2, line 8 or Schedule R-1, line 6)	_____
5	Add lines 2-4	_____
6	Subtract line 5 from line 1	_____
7	Add columns C and D of line 9	_____
8	Divide line 7 by line 6	_____
9	Trust's inclusion ratio. Subtract line 8 from 1.000	_____

GST exemption is allocated to this trust up to the entire value of assets transferred to the trust so the entire trust will have an inclusion ratio of zero and be entirely exemption from GST tax.

Part 1, Line 9, column E-trust's inclusion ratio. The trustee must know the trust's inclusion ratio to figure the trust's GST tax for future distributions and terminations. You are not required to inform the trustee of the inclusion ratio and may not have enough information to compute it. Therefore, you are not required to make an entry in column E. However, column E and the worksheet below, from the Instructions, are provided to assist you in computing the inclusion ratio for the trustee if you wish to do so.

The executor should inform the trustee of the amount of the GST exemption allocated to the trust. Line 9, column C and D may be used to compute this amount for each trust. See discussion below regarding division of trusts.

This worksheet will compute an accurate inclusion ratio only if the decedent was the only settlor of the trust. You should use a separate worksheet for each trust (or separate share of a trust that is treated as a separate trust).

Line 10- *Special use allocation.* For skip persons who receive an interest in Section 2032A special use property, you may allocate more GST exemption than the direct skip amount to reduce the additional GST tax that would be due when the interest is later disposed of or qualified use ceases. See Schedule A-1 of this Form 706 for more details about this additional GST tax.

Enter on line 10 the total additional GST exemption you are allocating to all skip persons who received any interest in Section 2032A property. Attach a special use allocation schedule listing each such skip person and the amount of the GST exemption allocated to that person.

Line 10 may be used to set aside an exemption amount for such an event. You must attach a schedule listing each such event and the amount of exemption allocated to that event.

[5] Division of trusts

The Economic Growth and Tax Relief Reconciliation Act of 2001, ratified IRC § 2642(a) to authorize a "qualified severance" of a trust into an exempt trust and a non-exempt trust subject to GST tax. IRC § 2642(a)(3)(B)(ii) permits a qualified severance "only if the single trust is divided into two trusts," whereas IRC § 2642(a)(3)(B)(i) defines "qualified severance" as the division of a single trust and the "creation of two or more trusts." The two trust limit of Section 2642(a)(3)(B)(ii) appears to require the initial division of a trust with an inclusion ratio greater than zero and thus subject to the GST tax into one trust with an inclusion ratio of zero and one trust with an inclusion ratio of one. Presumably, after that division, Section (B)(i) can be used to divide either one or both trusts into as many separate trust as desired.

The Texas Trust Code contains a procedure by which trusts can be divided for tax administration purposes. Texas Trust Code § 112.057.

IRC § 2654 permits a single trust to be treated as separate trusts because of (i) transfers from separate grantors or (ii) because the trust consists of substantially separate and independent shares of different beneficiaries. But this section does not actually authorize the division of a trust. It just permits a trust to be treated as separate trust for these, and only these, reasons.

There have been several private letter rulings in which a qualified severance was approved. PLRs 200420021, 200432003, and 200432005-009.

The Service has issued proposed regulations, Reg. 145987-03, on August 23, 2004, on qualified severance of a trust for generation-skipping transfer

tax purposes, providing guidance on the proper procedure, permissible timing, and required reporting of a qualified severance, as well as the permitted methods of funding the resulting trusts.

[6] Allocation of taxes

Parts 2 and 3. Use Part 2 to compute the GST tax on transfers in which the property interests transferred are to bear the GST tax on the transfers. Use Part 3 to report the GST tax on transfers in which the property interests transferred do not bear the GST tax on the transfers. IRC § 2603(b) requires that unless the governing instrument provides otherwise, the GST tax is to be charged to the property constituting the transfer. Therefore, you will usually enter all of the direct skips on Part 2. You may enter a transfer on Part 3 only if the will or trust instrument directs, by specific reference, that the GST tax is not to be paid from the transferred property interests.

The top portion of Parts 2 or 3 of Schedule R requests three items for each transfer:

(i) Name of skip person.

(ii) Description of property interest transferred. Specific gifts of property listed on the estate tax return should be identified by schedule and item, for example "Schedule A, Item 3, apartment building." General gifts or residuary gifts should describe the gift but need not list the specific property used to fund the gift. For example, "Cash or property in kind of a value of Five Hundred Thousand Dollars," or "Residuary of Decedent's probate estate."

Although it relates to the next item, because of the space available, this may be a good place to indicate if the value is based on a calculation and if the allocation is subject to a formula. To the author, it seems that the preparer would always want to allocate GST exemption using a formula on any asset whose value could be adjusted, which is just about every asset except cash or fixed pecuniary amounts.

(iii) The value of the property interest.

Unless stated otherwise, exemption will be allocated pro rata among the various transfers listed. If there are increases in exemption, state where the additions are allocated and if there are decreases in the available exemption, state from where the amount of the decrease will be taken. Complicated notices of allocation can be set forth on a separate Notice of Allocation.

Part 2, Line 3. Enter zero on this line unless the will or trust instrument specifies that the GST taxes will be paid by property other than that constituting the transfer (as described above). Enter on line 3 the total of the GST taxes shown on Part 3 and Schedule(s) R-1 that are payable out of the property interests shown on Part 2, line 1.

Part 2, Line 6. Do not enter more than the amount on line 5. Additional allocations may be made using Part 1.

Part 3, Line 3. See the instructions to Part 2, line 3, above. Enter only the total of the GST taxes shown on Schedule(s) R-1 that are payable out of the property interest shown on Part 3, line 1.

Part 3, Line 6. See the instructions to Part 2, line 6, above.

[C] How to Complete Schedule R-1

[1] Filing due date

Enter the due date of Schedule R, Form 706. You must send the copies of Schedule R-1 to the fiduciary by this date.

[2] Line 4

Do not enter more than the amount on line 3. If you wish to allocate an additional GST exemption, you must use Schedule R, Part 1. Making an entry on line 4 constitutes a Notice of Allocation of the decedent's GST exemption to the trust.

[3] Line 6

If the property interests entered on line 1 will not bear the GST tax, multiply line 6 by 55% (.55).

[4] Signature

The executor(s) must sign Schedule R-1 in the same manner as Form 706.

[5] Filing Schedule R-1

Attach to Form 706 one copy of each Schedule R-1 that you prepare. Send two copies of each Schedule R-1 to the fiduciary.

[6] GST tax payment

GST tax shown on Schedule R-1 is due nine months after the date of death. The trustees receive an automatic extension of time to pay GST tax until two months after the filing date (with extensions) of the estate tax return; interest accrues from the original due date, but no penalties are assessed.

21 SCHEDULE T - QUALIFIED FAMILY-OWNED BUSINESS INTEREST DEDUCTION

§21.01 *Exclusion of up to $675,000 in family business*

IRC § 2057 permits deducting the value of certain family-owned business interests from the gross estate. Schedule T must be filed to make the election.

[A] Amount excluded

For decedents dying in 1998, the amount of the deduction cannot exceed the lesser of:

(i) The adjusted value of the qualified family-owned business interests of the decedent otherwise includable in the gross estate, or

(ii) $675,000.

[B] Repealed effective 2004

The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the qualified family-owned business deduction for decedents dying after December 31, 2003. For elections before repeal, the 10-year recapture period would apply until expiration of the 10-year period.

§21.02 *Basic requirements*

The following requirements must be met for the qualified family-owned business interest deduction to apply:

[A] Citizen or resident requirement

The decedent must have been a citizen or resident of the United States on the date of death.

[B] Business interests includable

The business interests must be includable in the gross estate and be reported on Schedules A, B, C, F, G, or H of Form 706.

[C] Qualified heir

The interests must have passed to or been acquired by a *qualified heir* from the decedent. A person is a qualified heir of property if he or she is a *member of the decedent's family* and acquired or received the interest from the decedent. A member of the decedent's family includes:

- An ancestor (parent, grandparent, etc.) of the decedent;
- The spouse of the decedent;
- The lineal descendent (child, step-child, grandchild, etc.) of the decedent, the decedent's spouse, or a parent of the decedent (meaning niece, nephew, great niece, and great nephew of the decedent);
- The spouse, widow, or widower of any lineal descendant described above.

A legally adopted child of an individual is treated as a child of the individual by blood.

Qualified heir also includes any active employee of the trade or business to which the qualified family-owned business interest relates, if the employee has been employed by the trade or business for a period of at least 10 years before the date of the decedent's death.

[D] 50%

The *adjusted value* of the qualified family-owned business interests must exceed 50% of the *adjusted gross estate*.

[1] Adjusted value

Qualified family-owned business interests do not include the portion of an interest in a trade or business that is attributable to:

(1) Cash and/or marketable securities in excess of the reasonably expected day-to-day working capital needs, and

(2) Any other assets [prior to EGTRRA 2001 excluding assets held in the active conduct of a bank or domestic building and loan] which produce or are held for the production of personal holding company income and most types of foreign personal holding company income. See IRC § 2057(e)(2)(D).

The legislative history of IRC § 2057 suggests application of the *Bardaht* formula. *See, Mapes*, 99 TC No. 27 (1992) where the Tax Court applied a facts and circumstances test in the IRC § 2032A context.

How are IRC § 2053 and 2054 deductions to be handled? The words of IRC § 2057(d) say that all IRC § 2053 and 2054 deductions are to be deducted from the value of the business in the numerator. Schedule T and the Instructions follow this approach. It would appear to be unreasonable to charge the numerator with the entire amount of the liabilities when the business interest is less than the entire gross estate. It seems that the preparer should assert the position that the liabilities should be prorated based on the ratio of the business interest to the gross estate value.

[2] Qualified family-owned business interest

The business interest must be either an interest as a proprietor in a trade or business carried on as a proprietorship, or an interest in an entity carrying on a trade or business in which:

(1) At least 50% of the entity is owned by the decedent or members of the decedent's family;

(2) At least 70% of the entity is owned by members of two families, and at least 30% is owned by the decedent or members of the decedent's family; or

(3) At least 90% of the entity is owned by members of 3 families, and at least 30% is owned by the decedent or members of the decedent's family.

[3] Ownership

Ownership may be either direct or indirect, through a corporation, partnership, or trust. An interest owned, directly or indirectly, by or for such an entity is considered owned proportionately by or for the entity's shareholders, partners, or beneficiaries.

TAM 200410002 concluded that promissory notes issued by a family-owned business could not be deducted as qualified family-owned business interests. On Schedule T the executor claimed deductions for an amount equal to the principal and accrued interest due on five company notes. The TAM advised that the term "interest in an entity" as used in IRC § 2057(e)(1)(B) contemplates only an equity or ownership interest in the entity. The TAM noted that IRC § 2057(e)(1)(A) limits the interest that is deductible in the case of a proprietorship to only "an interest as a proprietor," which is clearly an ownership or equity interest. Logically, according to the TAM, the same limitation applies to interests covered in IRC § 2057(e)(1)(B). In common usage, an interest in an entity would normally reference an ownership interest such as stock or a partnership interest. There is no indication that the statute intended that ownership of promissory notes should be treated as an interest in the business. The holder of a promissory note of a corporation is a mere creditor of the entity and does not have any "interest in" the entity, as that term is commonly used. Furthermore, IRC § 2057(e)(2)(D)(i) provides that a "qualified family-owned business interest" does not include that portion of an interest that is attributable to cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. The TAM states that the use of the term "interest" in this section clearly comprehends an ownership interest in the entity to which a proportionate part of the underlying assets owned by the entity can be attributed. A debt instrument, on the other hand, represents a liability of the entity and assets held by the entity are not readily attributable to the liabilities of the entity.

[a] Corporations

Ownership of a corporation is determined by holding stock that has the appropriate percentage of the total combined voting power of all classes of stock entitled to vote and the appropriate percentage of the total value of shares of all classes of stock.

[b] Partnerships

Ownership of a partnership is based on owning the appropriate percentage of the capital interest in the partnership.

[c] Trusts

A person is the beneficiary of a trust only if he or she has a present interest in the trust.

[d] Tiered entities

> For the purpose of determining ownership of a business under section 2057, if the decedent, a member of the decedent's family, any qualified heir, or any member of the qualified heir's family owns an interest in a business, and by reason of that ownership the person is treated as owning an interest in any other business, the ownership interest in the other business is disregarded in determining the ownership interest in the first business. Likewise, you must apply the ownership rules separately in determining ownership of the other business.
>
> Instructions, p. 22.

[4] Not qualified

"Qualified family-owned business interests" do not include:

(1) Any interest in an entity if the stock or debt of the entity (or a controlled group of which the entity is a member) was readily tradable on an established securities market or secondary market at any time within 3 years of the date of the decedent's death.

(2) Any interest in a trade or business (excluding banks and domestic building and loan associations) if more than 35% of its adjusted ordinary gross income for the taxable year that includes the date of the decedent's death would qualify as personal holding company income (as defined in IRC § 2057(e)(2)(C)) if such trade or business was a corporation.

[E] U.S. place of business

The interest must be in a trade or business that has its principal place of business in the United States. The interest does not qualify if the principal place of business is located outside the United States.

[F] Ownership

The business interest was owned by the decedent as a member of the decedent's family during 5 of the 8 years before the decedent's death.

[G] Material participation

For 5 of the 8 years before the decedent's death, there was material participation by the decedent or a member of the decedent's family in the business to which the ownership interest relates.

> The existence of material participation is a factual determination, and the types of activities and financial risks that will support a finding of material participation will vary with the mode of ownership. No single factor is determinative of the presence of material participation, but physical work and participation in management

decisions are the principal factors to be considered. Passively collecting rents, salaries, draws, dividends, or other income from the trade or business does not constitute material participation. Neither does merely advancing capital and reviewing business plans and financial reports each business year.
Instructions, p. 23.

The preparer should prepare a record of material participation by the decedent.

[H] Extension of time to elect

Several private letter rulings have granted extensions pursuant to Treas. Reg. §301.9100-1 and Treas. Reg. §301.9100-3 to make an election under IRC § 2057. PLRs 200422044, 200450027, 200504004, 200505016.

§21.03 *The Schedule T*

[A] Partial elections permitted

The instructions to Line 15 make it clear that a partial election is permitted, when it says "You may choose, however, not to deduct on Schedule T all of the trade or business interests that are listed on line 5."

In making partial elections, adjustments in the value of the gross estate may invalidate the election as happened in TAM 200430030. The qualified family owned business consisted of two tracts of farmland and a bank account. Property 2 was devised to the decedent's daughter but she sold it to unrelated parties during the administration of the estate. The estate tax return reported the adjusted value of Property 1 and the bank account exceeded 50 percent of the value of the adjusted gross estate, but on audit the Service found that the decedent's gifts made within three years of death expanded the size of the estate to the point where the adjusted value of Property 1 and the bank account failed to exceed 50 percent of the value of the adjusted gross estate. As to Property 2 it was not listed on Schedule T of the estate tax return as a QFOB and the qualified heirs did not consent to the recapture tax provisions under IRC § 2057(f) with respect to that property. Hence, the election was found invalid.

[B] Marital deduction double-dipping

IRC § 2057(b)(9) denies a double deduction and the line 15 instructions say, "[I]f a trade or business interest that is a qualified family-owned business interest passes to the surviving spouse and you choose to deduct it on Schedule M, you may not deduct on Schedule T the part of its value deducted on Schedule M.

22 SCHEDULE U - QUALIFIED CONSERVATION EASEMENT EXCLUSION

§22.01 *Election*

Under IRC § 2031(c), the estate may elect to exclude a portion of the value of land that is subject to a qualified conservation easement. The election is made by filing Schedule U with all of the required information and excluding the applicable value of the land that is subject to the easement on the recapitulation. The election is irrevocable.

[A] Excluded interest included

The estate must include on Schedules A, B, E, F, G, or H, as appropriate, the decedent's interest in the land that is subject to the exclusion.

[B] When made

The election must be made on a timely filed Form 706, including extensions.

[C] Amount

For the estate of decedents dying in 1998, the exclusion is the lesser of:

(i) the applicable percentage of the value of land (after certain reductions) subject to a qualified conservation easement, or

(ii) an amount depending upon the year of death.

1998 …….$100,000
1999……200,000
2000……300,000
2001……400,000
2002 or thereafter ……..500,000

[D] Applicable percentage defined

The applicable percentage is 40% reduced by 2 percentage points for each percentage point or fraction thereof by which the value of the qualified conservation easement is less than 30% of the value of the land (determined without regard to the value of the easement and reduced by the value of any retained development right.) IRC § 2031(c)(2).

[1] Funds

When a post-death easement is being considered and the conservation agency requests an enforcement fund and related expenses, how can such funds qualify for an estate tax deduction? There is no provision for deducting funds as part of the

conservation easement. The funds would not constitute a transfer from the decedent and thus would not qualify for a charitable deduction. Possibly it may qualify as an administration expense. If the funds come from the surviving spouse, the contribution will qualify for an income tax deduction.

§22.02 *Examples*

Some examples help us to understand how the qualified conservation easement exclusion works.[6]

[A] Pre-death donation

Mr. Land, owner of ABC Ranch, donated in 2000 a conservation easement on 1000 acres of open hand, permitting continuing agricultural and ranching activities, but otherwise permitting no further development and prohibiting commercial recreational activities. Before the easement, the land was valued at $1.5 million, and the easement reduced the ranch value to $1 million, the same value the ranch has in 2001 when Mr. Land dies. Assume the easement met all requirements of IRC § 170(h) and all requirements of IRC § 2031(c) are met.

Analysis: Mr. Land is entitled to a $500,000 income tax deduction upon donating the easement. The ranch is valued at $1 million in the estate, and the estate is eligible for the IRC § 2031(c) exclusion, which reduces the value of the land to $600,000 (excluding 40% of $1 million). If the executor claims the exclusion, $600,000 of land value will be subject to tax.

[B] Post-death donation by will

(These facts are similar to the previous example, except the donation is made post death.) Mr. Land, owner of ABC Ranch, died in 2001 when the ranch is worth $1.5 million. The will donates the easement and the value of the ranch after the easement is $1 million.

Analysis: There is no income tax deduction because the easement was not donated during life. The full value of the ranch is included in the estate ($1.5 million). The estate receives an estate tax deduction under IRC § 2055(f) for the $500,000 value of the easement. The estate is taxed at a net $1 million, same as in the pre-death donation, and the estate is eligible for the IRC § 2031(c) of $400,000. Thus, the difference is that the income tax deduction is only available for the lifetime donation.

[C] Post-death donation by heirs

(These facts are similar to the previous example, except the heirs make the donation.) Mr. Land, owner of ABC Ranch, died in 2001 when the ranch was worth $1.5 million, with a simple will that gave the ranch to his 3 children. The children donated post-mortem the conservation easement.

Analysis: The estate will be entitled to an estate tax charitable deduction under IRC § 2055(f) for the value of the easement and the estate is eligible for the IRC § 2031(c) exclusion. This is the same tax result as if the easement was provided for in the will.

[D] Post-death donation by will of co-owner

Mr. Land and his wife own ABC Ranch as community property. Upon Mr. Land's death, his will included a conservation easement on ABC Ranch.

Analysis: The easement donation in Mr. Land's will is probably ineffective, because he cannot give an easement on just his undivided interest.

[E] Post-death donation by co-owner and heirs

Mr. Land and his wife own ABC Ranch as community property. Mr. Land died in 2001 when the ranch was worth $1.5 million, with a simple will that gave the ranch to his 3 children. The children join with Mrs. Land donating post-mortem the conservation easement.

Analysis: The estate will be entitled to an estate tax charitable deduction under IRC § 2055(f) for the value of the easement, and the estate is eligible for the IRC § 2031(c) exclusion on Mr. Land's undivided interest. Mrs. Land is entitled to the IRC § 170(h) deduction.

The finding in this analysis was similar to the ruling in PLR 200143011. The decedent's estate included through a revocable trust a 33.4% interest in land and through a general power of appointment marital trust a 35.4% interest. Two children each held a 15.6% interest in the land. The trustees of the trust and the two children conveyed a conservation easement after the decedent's death and before the time for filing the estate tax return. The two children were the heirs of the trusts. Under IRC § 2031(c)(9) when a qualified conservation easement is contributed after a decedent's death, the estate tax deduction provided for in IRC § 2055(f) is allowed only if no income tax deduction is allowed to the estate or the qualified heirs with respect to the post-death grant of the conservation easement, citing S. Rep. No. 105-174, 105th Cong. 2d Sess. 160 (1998). The ruling noted that the childrens' co-tenancy interests were not included in the decedent's estate and no IRC § 2055(f) deduction was taken for those interests. The IRS ruled that the estate may claim a deduction under IRC § 2055(f) for the value of the conservation easement attributable to the 68.8% co-tenancy included in the decedent's estate,

[6] This discussion is based in part on Small, 87 TAX NOTES 435 (April 17, 2000).

notwithstanding that the two children will claim a deduction under IRC § 170(h) for the conservation easements granted with respect to the interests they owned.

§22.03 *Basic requirements*

To obtain the exclusion, the land must meet ownership, qualified conservation easement, and location requirements.

[A] Ownership

The decedent or a member of the decedent's family must have owned the land for the 3-year period ending on the date of the decedent's death.

a. Members of the decedent's family include the decedent's spouse; ancestors; lineal descendants of the decedent, of the decedent's spouse, and of the parents of the decedent; and the spouse of any lineal descendant. A legally adopted child of an individual is considered a child of the individual by blood.

[B] Location

As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA 2001") the qualified conservation easements apply to any property in the United States that meets applicable requirements, because the previous geographic location requirements we deemed too complex. Prior to EGTRRA 2001, the land must be located:

a. In or within 25 miles of an area which, on the date of the decedent's death, is a metropolitan area, as defined by the Office of Management and Budget.

b. In or within 25 miles of an area which, on the date of the decedent's death, is a national park or wilderness area designated as part of the National Wilderness Preservation System (unless it has been determined that such land is not under significant development pressure); or

c. In or within 10 miles of an area which, on the date of the decedent's death, is an Urban National forest, as designated by the Forest Service.

[C] Qualified conservation easement

No later than the date the election is made, a qualified conservation easement on the land must have been made by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust that holds the land.

[1] Requirements

A deduction is permitted with respect to transfer of a qualified real property interest defined in IRC § 170(h)(2)(C) (which in turn is defined as a restriction granted in perpetuity on the use which may be made of the real property) which meets the requirements of Section 170(h) without the regard to the requirement of having a "conservation purpose." The lack of need to meet a conservation purpose test under Section 170(h) was to avoid loss of the estate tax deduction in the event that the test was not satisfied subsequent to estate transfer.

[2] Qualified real property interest

The term "qualified real property interest" means any of the following:

(1) the entire interest of the donor, other than a qualified mineral interest;

(2) A remainder interest;

(3) A restriction granted in perpetuity on the use that may be made of the real property. The restriction must include a prohibition on more than a de minimus use for commercial recreational activity.

[3] Qualified organization

Qualified organizations include:

(1) The United States, a possession of the United States, a state (or the District of Columbia), or a political subdivision of them, as long as the gift is for exclusively public purposes.

(2) A domestic entity that meets the general requirements for qualifying as a charity under IRC § 170(c)(2) and which generally receives a substantial amount of its support from a government unit or from the general public.

(3) An entity qualified under IRC § 170(h)(3)(B). That is an organization that is described in IRC § 501(c)(3) and is a public charity described in IRC § 509(a)(2) that meets the one-third public support test and the one-third investment income test or is a public charity described in IRC § 509(a)(3) that is a controlled organization.

23 CLOSING LETTERS AND CLOSING AGREEMENTS

§23.01 *Closing letters*

When an estate Form 706 is not audited or an audit is complete, the IRS will send an estate tax closing letter to the executor. The closing letter is evidence that the Form 706 has been accepted as filed or accepted after adjustments agreed to by the IRS and the executor. The IRS will not reopen a case to make an adjustment unfavorable to the taxpayer unless:

(1) There is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact; or

(2) The prior closing involved a clearly defined substantial error based on an established IRS position existing at the time of the previous examination; or

(3) Other circumstances exist that indicate failure to reopen would be a serious administrative omission. Rev. Proc. 94-68, 1994-44 I.R.B. 16.

§23.02 *Closing agreements*

A formal closing agreement under IRC § 7121 cannot be reopened by the IRS. Rev. Rul. 72-487,197202 CB 645, ruled that execution and approval of a closing agreement does not preclude an additional inspection of a taxpayer's records to determine whether fraud, malfeasance, or misrepresentation of material fact exists in connection with the execution of the agreement.

§23.03 *Distinctions*

In *Estate of Cameron Bommer v. Comm.*, 69 TCM (CCH) 2541 (1995), the decedent owned closely held stock that was reported on the estate tax return. The return was audited and the district director issued a closing letter. The closing letter stated that it did not constitute a formal closing agreement under Section 7121 and that the Internal Revenue Service would not reopen the case unless Rev. Proc. 85-13, 1985-1 CB 514 (since superseded by Rev. Proc. 94-68, I.R.B. 1994-44, 16), applied. Over a year later the district director reopened the examination of the estate's return claiming that failure to do so would result in a "Serious Administrative Omission." As a result of this second examination the Service increased the value of the closely held stock and issued a deficiency of $5.5 million for additional estate and generation-skipping transfer taxes. The Tax Court held that absent a formal closing agreement, the IRS may reopen a case and determine a deficiency notwithstanding the issuance of an estate tax closing letter. The closing letter cannot be characterized as a contract given it unambiguously stated that it did not constitute a closing agreement under Section 7121. The estate argued that the Service abused its discretion by reopening a closed examination and disregarding the Service's self-imposed restrictions. The closing letter incorporated these internal procedures by the closing letter's clear reference to them. The Tax Court stated that no closing agreement means that the case is not closed.

When the examination is reopened in accordance with the terms of the closing letter, the estate may attempt to argue that the IRS is estopped. In *Estate of Brocato v. Comm.*, TC Memo 1999-424, the Tax Court held that the IRS was not estopped from reopening an estate tax examination. The return was selected for audit and the estate was informed that the IRS was hiring an appraiser for real property reported on the return. The IRS by a clerical mistake issued a closing letter. The IRS informed the estate that it was still in the process of hiring an appraiser, and the estate brought the closing letter to the IRS's attention. The estate argued that the IRS was estopped from reopening the examination. The Tax Court reviewed the traditional elements of estoppel as well as the Ninth Circuit to which the case would be appealed. The Ninth Circuit requires affirmative misconduct going beyond mere negligence by the government and the Tax Court found that the mere issuance of the closing letter did not amount to affirmative misconduct going beyond mere negligence. The Tax Court also stated that the estate's reliance on the closing letter was not reasonable and that the estate failed to state a claim of detriment in reliance on the closing letter.

§23.04 *Closing letter preparation*

Beginning with the Form 706 for decedents dying in 2001, a blank copy of the "Estate Tax Closing Document" is included to expedite closing the estate. Instructions, p. 1. The instructions on the back of the draft closing document request that the preparer complete entries for:

Executor or POA name
Address
Estate name
Decedent's social security number
Date of death

The completed document is to be filed with the Form 706 to expedite processing.

POA means "power of attorney," but there is no discussion requiring that a Form 2848 be filed with the return or what the consequence is of filing the letter with the name of the POA but with no Form 2848 attached. On page 2 of the return, the person named to receive confidential information and to represent the estate before the IRS is termed the "representative." Without further guidance, the cautious preparer will include the executor's name and not the POA's, but the POA can be listed as "cc:." If done so, include the POA's address. No guidance is given on what to do when there are two or more executors, but notice that instructions state that the executor listed on page one will be the one contacted by the IRS. Instructions, p. 4. No guidance is given as to the consequence of this name or address being different from the name and address listed on page one.

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Warning:
May Not Comply With Circular 230 After June 20, 2005

APPENDIX A

This memorandum would be drafted for the particular client Paragraphs indicated by ? would be selected and included in the memorandum only if appropriate for the client and the estate.

LAW OFFICES
MEMORANDUM

FILE: 12345.678 DATE: June 30, 2004

TO: Richard V. Sample
FROM: Glen A. Yale Confidential and Privileged

SUBJECT: Review of Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return

One of your most important responsibilities as independent Executor of the Estate of your father is the filing of the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. You must file the return within nine months after the date of the decedent's death, unless an extension to file is granted.

You are required to sign the Form 706, which contains a statement saying "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." While we will sign the return as preparers, in preparing the Form 706, we of necessity must rely on the information you provide to us. Thus, it is your responsibility to make sure the information contained on the Form 706 is complete and accurate to the best of your knowledge.

Preparing the Form 706, we will use or refer to documents prepared by others, including but not limited to, deeds, legal descriptions of real property, agreements, registrations, financial statements, tax returns, bank statements and certificates. Even though we may use information contained in such documents prepared by others or use the documents themselves, you should not take such use to be an opinion as to the accuracy or legal effectiveness of such documents. If you want us to review and be responsible for the accuracy and legal effectiveness of documents prepared by others, then that needs to be included in a new written engagement letter. Under our current engagement, our firm is not engaged to review for the general accuracy of, nor is it responsible for the legal effectiveness of, documents prepared by others.

Some of the information that must be reported is obvious from the requests made on the Form 706. Some of the questions on the Form 706 are not as clear and an explanation of the request may help your understanding. All references to Sections in this memorandum are to Sections in the Internal Revenue Code.

Part 2, Line I5

The estate is entitled to a credit for federal gift taxes on transfers which are included in the gross estate and which are made before January 1, 1977. The amount of the credit is limited to the lesser of the gift tax paid on the gifts which are included in the gross estate or the amount of estate tax attributable to the inclusion of the gifts in the decedent's gross estate. We have included the amount paid on the 1976 gift. Because no tax was paid on pre-1977 transfers, the amount of this line is zero.

Part 2, Line 12

? This entry shows the total estate taxes, both state and federal, due. Increases in the value of the assets listed on the return may result in tax due The use of the unified credit and the marital deduction result in there being no tax due on this return, as prepared.

? This entry shows the total estate taxes, both state and federal, due. Increases in the value of the assets and decreases in the expenses and debts listed on the return may increase the tax due. Decreases in the value of the

assets and increases in the expenses and debts listed on the return may decrease the taxes due.

Part 2, Line 17, Credit Or Tax On Prior Transfers

This line is zero. If your father inherited property within ten years of his date of death or was a beneficiary of a trust created upon the death of another person within ten years of the date of death, and the estate from which the property was inherited paid estate taxes, then this Estate may be entitled to a credit for those taxes paid. Please let us know if any property was inherited or a trust was created upon death of another person within ten years of the date of death. If we do not hear from you, we will assume that there is no such property in the Estate. You did provide a copy of the estate tax return for your grandmother, and it shows no tax paid so no credit is available from that estate.

Part 2, Line 19, Net Estate Tax

? This entry shows the total taxes due. Increases in the value of the assets listed on the return may increase the tax due. Increases in the expenses will decrease the tax due.

? This entry shows the total taxes due. Because a payment was made with the extension, a refund is requested. Increases in the value of the assets listed on the return may increase the tax due. Increases in the expenses will decrease the tax due and increase the refund.

Part 3, Question 1, Alternate Valuation

You can elect to value the Estate using the alternate valuation date. Normally all property must be valued as of the date of death, The alternate valuation date is (i) the date the property is distributed, sold, exchanged or otherwise disposed of within six months of the date of death, or (ii) six months after the date of death for all other property not distributed, sold, exchanged, or otherwise disposed of within six months. Alternate valuation is important if tax is due on the Form 706, and the value of the property significantly decreased from the date of death until the alternate valuation date. Once the Form 706 is filed, the alternate valuation election is final. If elected, alternate valuation must apply to all property in the Estate. It cannot apply to some but not all of the items Use of alternate valuation does not exclude the use of special use valuation, explained below.

? Because less tax is due on the Form 706 under alternate valuation, alternate valuation is elected.

? Because less tax is due on the Form 706 under date of death values rather than alternate valuation values, alternate valuation cannot be elected.

? Because no tax is due on the Form 706, alternate valuation is not elected.

Part 3, Question 2, Special Use Valuation

Real property used in a farm or closely held business can be valued at its farm or business use value rather than its fair market value. This is called special use value.

? The Form 706 does not elect special use value because there is no real property used in a farm or closely held business.

? The Form 706 makes a protective election for special use value in case the value of the Estate is increased on audit.

? The Form 706 makes an election for special use value on the ranch. This results in the ranch being valued $_____ rather than $_____, and avoids the payment of $_____ in taxes. Attached you will find a draft of the first pages of a Form 706 that would apply if no special use election is made.

Part 3, Question 3, Pay Taxes in Installments

Normally all estate taxes are due nine months after the date of death. Under certain circumstances, primarily involving taxes resulting from a closely held business, the taxes can be paid in installments.

? Because there are adequate funds to pay all estate taxes due, there will be no installment payments.

? Because there are no estate taxes due, there will be no installment payments.

? Because there are no estate taxes due, there will be no installment payments. A protective election is taken in case upon audit tax becomes due and substantial value is assigned to the business.

? Because you are requesting an extension of time in which to pay estate taxes, you are electing installment payment, and this question is answered yes.

Part 3, Question 4, Defer Taxes on Reversionary Interests

A remainder interest in property after a life estate or term of years in another person must be included in the Estate at its fair market value. The Estate can elect to pay the taxes after the life estate or the term of years terminates

The Estate does not own a remainder interest, so the answer to this question is *no*.

Part 4, Line 5

Please confirm that we have correctly spelled the names and correctly entered the social security number. The amounts passing to each should be regarded as "ballpark" figures rather than being exact.

Attached to the draft estate tax return is a spreadsheet that shows each item from the estate tax return, how the item is distributed and the amount passing to each beneficiary. This spreadsheet is not filed with the estate tax return and is included for information purposes.

Part 4, Question 6, section 2044 Property

Section 2044 property is property for which a previous qualified terminable interest property (QTIP) marital deduction election was made, either under the estate tax or gift tax rules. If your father received from your mother a life estate, with the remainder interest passing to another, then the property will be Section 2044 QTIP property if the QTIP election was made. The full fair market value of the Section 2044 QTIP property is included in the Estate and subject to the estate tax rules.

? The Form 706 says there was no QTIP property included in the Estate. If there is QTIP property to be included in the Estate, then you must let us know.

? The Form 706 says there was no QTIP property included in the Estate, because your father's last marriage terminated before the Congress provided for QTIP property.

Part 4, Question 7, Federal Gift Tax Returns

If your father made any gifts after December 31, 1981, to persons other than his wife, and the total amount of the gifts in any one calendar year to any one person exceeded $10,000, ($11,000 in 2002) then it was necessary to file a gift tax return to report the gifts. The gifts are taxable, but no gift tax needs to be paid to the extent the value of the gift tax does not exceed your father's unified credit. However, the gift reduces the amount of the unified credit against estate and gift taxes and thereby effects the amount that can pass estate tax free in your father's Estate. If any gift tax returns were filed, then we need to report that on the Form 706. If no returns were filed, but gift tax returns should have been filed, then it is your responsibility to file the returns. You must make a reasonable inquiry as to the existence of any such unreported gifts.

? You informed us that to your knowledge no returns have been filed and your father made several gifts that required the filing of a gift tax return. Drafts of the gift tax returns to be filed are attached to the return.

? You informed us that to your knowledge no returns have been filed and your father made no gifts that required the filing of a gift tax return. Please let us know if that information is no longer correct. We wrote the Internal Revenue Service to request any gift tax returns they had on file, and we have not yet received an answer to that inquiry.

? You informed us that to your knowledge no returns have been filed and your father made no gifts that required the filing of a gift tax return. Please let us know if that information is no longer correct.

? You informed us that to your knowledge no returns have been filed and your father made several gifts. It appears that your father made gifts of the Bexar County land that required the filing of a gift tax return. Once we agree on the remaining information in the return, we will revise the return to including filing a gift tax return on the prior gifts.

? We wrote the Internal Revenue Service to request any gift tax returns that they had on file, and we received a reply that they did not have any. We include in the Form 706 a copy of the 1993 Gift Tax Return.

? We were provided copies of two gift tax returns and they are included in the estate tax return. If you are aware of additional gift tax returns, then they need to be brought to our attention so they can be included in the return.

Part 4, Question 8a, Insurance On Decedent's Life

The Form 706 must list all life insurance policies on the life of your father, regardless of who owned the policy or who was the beneficiary. If your father did not possess any of the incidents of ownership, then it is possible that the proceeds will not be included in the gross Estate. This can happen, for example, if the policy is owned by someone else, or the policy is held in an irrevocable life insurance trust. If there are any policies, the proceeds of which are not included in the Estate, then this question must be answered yes.

? There was only one life insurance policy on the life of your father and it entirely is included in the Estate, so this question is answered no.

? There were several life insurance policies on the life of your father and they entirely are included in the Estate, so this question is answered no.

? You informed us that there was no life insurance on the life of your father, so this question is answered no. Let us know if that is not correct.

? There was only one life insurance policy on the life of your father and only the community half is included in the Estate, so this question is answered yes.

? There was one life insurance policy of the life of your father owned by the irrevocable life insurance trust and it is not included in the Estate. So, this question is answered yes.

Part 4, Question 8b, Insurance On Another

If your father owned a life insurance policy on the life of another person and the policy is not included in the Estate, then this question must be answered yes. (This question is not concerned with life insurance proceeds that your father received as beneficiary of a life insurance policy when the insured predeceased your father.)

? Because you informed us that your father owned no life insurance on the life of anyone else, this question is answered no.

? Because you have not informed us that your father owned life insurance on the life of anyone else, this question is answered no.

? Because you informed us that your father had one life insurance policy on your life and it is included in the Estate, this question has been answered no.

? Because you informed us that neither your father nor your mother had any life insurance on the life of anyone, this question has been answered no.

? Your father owned as community property a policy on the life of your mother, and because half of the value of the policy is included in the Estate this question is answered no.

Part 4, Question 9, Rights Of Survivorship

This question has two parts. First, we must determine if your father owned property as a joint tenant with rights of survivorship, and the other joint tenant was someone other than your mother. If your father did not own any joint properly with rights of survivorship, then the answer to this part is no and the answer to the entire question is no. Bank accounts are frequently owned as joint accounts, and the signature card or account agreement will indicate whether or not it is a joint account with rights of survivorship.

If the answer to the first part of the question is yes, then it must be determined if all of the property is to be included in the Estate. If a portion of the jointly owned property belonged to someone other than your father, then not all of the property will be included in the Estate, and this question must be answered yes. If all of the property is included in the Estate, then the answer is no.

? You informed us that your father did own property as joint tenants with rights of survivorship, but all of the property is included in the Estate, so the answer to this question is no.

? You informed us that your father and mother did not own any property as joint tenants with rights of survivorship, so the answer to this question is no.

? So far, we are unaware of any property owned as joint tenants with rights of survivorship, so this question is answered no.

? So far, we are unaware of any property owned as joint tenants with rights of survivorship, so this question is answered no. However, some of the bank accounts may be held in joint accounts with rights of survivorship. If we determine that some are, then we will need to take another look at this question. Joint accounts with rights of survivorship are more fully discussed below.

? You informed us that your father did own property as joint tenants with rights of survivorship, but with his wife, so the answer to this question is no.

? You informed us that your father did own property as joint tenants with rights of survivorship, with someone other than his spouse as the joint tenant, and some of the property is not included in his Estate so the answer to this question is yes.

Part 4, Question 10, Closely Held Business

This question must be answered yes if any one of four situations is true. (1) If your father owned an interest in a partnership, regardless of whether the partnership was subject to a written or an oral agreement, or whether the partnership was limited or general, then the answer is yes. (2) If your father had an interest in a sole proprietorship, then the answer is yes. (A business will still be considered to be a sole proprietorship, even if your mother had a community property interest in the business.) (3) If your father owned stock in a closely held corporation, then the answer is yes. (4) The answer is also yes, if your father had an interest in an inactive corporation.

? Your father owned an interest in a limited partnership, so the answer to this question is yes.

? Your father owned stock in a closely held corporation, XYZ Corporation, so the answer to this question is yes.

? You informed us that none of these situations are applicable, so the answer to this question is no.

? Your father owned as interest in a ranching operation, a sole proprietorship, so the answer to this question is yes.

Part 4, Question 11, Certain Transfers

This question inquires concerning four situations, anyone of which being true will require a yes answer to this question.

First, it asks if your father made a transfer described in Section 2035. Section 2035 transfers are mostly limited to gifts within three year's of death by your father of life insurance policies on the life of your father.

Section 2036 refers to transfers in which your father retained the right to use the property. For example, if he sold or gave another the right to use property after his death, but retained the right to use the property or receive the income from it during his life, the property will be Section 2036 property and the entire fair market value of the property will be included in the Estate. The right to use the property can either be explicit or be implied. For example, if he gave another property, but there was an understanding that your father could use the property anytime he wanted, the property is Section 2036 property and is included in the Estate.

Section 2037 includes transfers in which the final ownership of the property is not vested unless the beneficiary survives your father, and immediately prior to death there is a greater than 5% chance that the property can vest in your father. This provision is of concern only if your father made a transfer in trust or through a life estate.

Section 2038 includes transfers that are revocable or over which your father retained a power of appointment Examples will include trusts created by your father in which he had the right to revoke the trust and vest all of the property in himself. Another example is his creation of a power of appointment and reserving to himself the power to designate who will receive the property by exercising the power of appointment. If any one of these situations occur, then the answer to the question is yes. If none of the situations occur, then the answer is no.

? The question is answered no. Let us know if there were any of these transfers.

? The question is answered yes because of the revocable trust.

? The question is answered yes because of the taxable gifts made within three year's of the date of death.

Part 4, Question I2a, Trusts

If your father created any trusts during his life, then the answer to this question is yes. If your father transferred property to a trust, even if he was not named as the grantor on the trust agreement, then your father may be treated as a creator of the trust for purposes of this question. If your father created any trusts, copies of the trust agreements must be included as part of the Form 706.

? You informed us that your father created no trusts and transferred no property to any trusts, so this question is answered no. (This question is not concerned with trusts created under his will.)

? You informed us that your father created The John Q. Sample Family Trust and transferred property to it, so this question is answered yes.

Part 4, Question 12b, Powers, Beneficial interest, Or Trusteeship

If your father was a beneficiary of any trust, either currently or contingently, then the answer to this question is yes. Also, the answer to this question is yes if your father was serving as trustee of any trust at the time of his death. This question only applies to trusts as to which the grantor was someone other than your father.

? Because your father was a beneficiary of a trust established by your grandfather and the trust was not completely distributed on the date of death, this question is answered yes.

? You informed me that your father was neither a beneficiary nor a trustee of any trust created by another, so this question is answered no.

Part 4, Question 13, General Power Of Appointment

A general power of appointment is any power or interest in a trust by which your father could vest the property in himself, in his creditors, in his Estate, or in the creditors of his Estate. If he has a power to appoint to someone other than himself, his creditors, his Estate, or the creditors of his Estate, then the power is a power of appointment, but not a general power of appointment.

If your father ever had a general power of appointment, during his life or at the time of his death, then the value of the property subject to the power will be included in his Estate. The Form 706 must include a copy of the instrument creating the power.

? You informed us that your father did not hold such a power, so this Form 706 has been prepared as if there was no general power of appointment.

? Your father held a general power of appointment under The William Smith Trust of 1968, so this question is answered yes and the property subject to the power is included on the return.

Part 4, Question 14, Marital Deduction

? This question deals with qualification for the marital deduction. Because your father was not married at the time of his death, the answer to this question is no.

? If the will was signed before September 12, 1981, and it gives your father the maximum marital deduction, then the gift may be subject to certain limitations of the Economic Recovery Tax Act (ERTA) transitional rule. If the will was signed after September 12, 1981, then the ERTA transitional rule does not apply. Your father's will was dated September 13, 1981, so the ERTA transitional rule does not apply and the answer to this question is no.

? If the will was signed before September 12, 1981, and it gives your father the maximum marital deduction, then the gift may be subject to certain limitations of the Economic Recovery Tax Act (ERTA) transitional rule. If the will was signed after September 12, 1981, then the ERTA transitional rule does not apply. Your father's will was dated September 1, 1981, but the ERTA transitional rule does not apply because the will does not make a "maximum marital deduction gift." The answer to this question is no.

Part 4, Question 15, Annuity

If your father was receiving a certain type of annuity, then the answer to this question will be yes, and the annuity needs to be reported.

Your father was not receiving any annuities, so the answer to this question is no.

THE SCHEDULES

The remainder of the Form 706 includes the information on the property that you provided. The listing of the property must be complete, and we are relying on you for that information. There are two elements to each item. First, there is an accurate description of the item. Second, each item must be appropriately valued.

? There are penalties for underpayment of estate taxes of $1,000 or more that are attributable to valuation understatements. Thus, there is an incentive to correctly value each item on the return. The values on this Form 706 can establish the basis of the property. If an asset is sold and the basis for determining gain is the value on this Form 706, then a valuation understatement could occur and the penalty could be invoked.

? There are penalties for underpayment of estate taxes of $1,000 or more that are attributable to valuation understatements. Because there are no estate taxes due, the penalties for understatement will not apply on this Form 706. The values on this Form 706 can establish the basis of the property. If an asset is sold and the basis for determining gain is the value on this Form 706, then a valuation understatement could occur and the penalty could be invoked. Even though no tax is due, the values should be accurate.

The computer program that prepares the estate tax return rounds figures to the nearest dollar. Please review the Schedules carefully and make sure they contain a listing of all of the property that your father owned.

? Based upon the information made available to us we allocated the property between community property and separate property. Community property generally includes any property acquired during marriage, but it does not include property inherited from another, which is separate property. To the extent it is identifiable as such, the property your father inherited from his mother or father or purchased or exchanged for property inherited from them, should be listed as his separate property. If the property cannot be shown to be separate, then it is community property. If the property is separate property, then all of it is includable in your father's estate. On the other hand, if the property is community property, only one-half is includable in the Estate. Identifying more property as separate property will enhance the value of the Estate and will have the effect of increasing the general gift made to the trust for the benefit of Eleanor Smith Jones. Failure to identify property as separate property and treating it as community property has the effect of decreasing the general gift to Eleanor's trust. As Executor of the Estate you have a fiduciary obligation to be fair in making determinations as to what is separate and what is community.

Schedule A-Real Estate

? The residence is valued at its ad valorem value. Generally, the IRS accepts the ad valorem value, but they may require that the property be appraised. There is a substantial variance between the ad valorem value and the listing price. If the property sells soon, then you will probably need to adjust the value to be closer to the sales price.

? The residence is valued at the price for which it sold. The best indication of value is what an unrelated third party is willing to pay for something. The selling expenses are listed on Schedule J, and are properly deductible, because the estate was forced to sell property to pay estate taxes and expenses of administration.

Schedule A-1 - Special Use Valuation

? The home ranch is valued at its special use value. This results in a savings of approximately $210,000 in taxes. With this election, there is a recoupment tax if you and Dixie C. Sample sell the property within ten years or you and Dixie C. Sample discontinue the agricultural use within that 10-year period. The tax liability is effectively shifted from the estate to you and Dixie. Also, you and Dixie receive the surface of the property with an extremely low basis of $38,045. If you sell the property after the ten year period, you will have a larger capital gain as a result of special use value. To complete this schedule we will need Dixie's address. She will need to sign this as well as you. The Affidavit Confirming Material Participation is attached. You will need to sign this in front

of a notary public and should confirm that the statements of fact contain in the affidavit are correct.

Schedule B -Stocks And Bonds

? The values for the stocks come from a valuation service to which we subscribe, and the values may vary slightly from the values you provided.

? These are the stocks owned outside the partnership. The values come from a valuation service to which we subscribe, and the values vary slightly from the values you provided.

Schedule C - Mortgages Notes And Cash

? All of your father's interest in the bank accounts are listed on this Schedule. The figures were extracted from the bank statements provided and we have interpolated the accrued interest figures. When filing the return, we do not normally include a copy of the bank statements, because they are not requested in the instructions.

? All of your father's interest in the bank accounts and certificates of deposit are listed on this Schedule. Some of the names on the bank statements suggest that they are joint accounts with rights of survivorship. Joint accounts with rights of survivorship are not included in the probate. Estate and do not pass under the will. However, they are included in the federal gross estate. Joint accounts with rights of survivorship should properly be reported on Schedule E of the return. Please obtain a copy of the signature card on each bank account so we can confirm whether the accounts are joint accounts with rights of survivorship.

Schedule D - Life Insurance on the Decedent's Life

? Several of the policies had post-mortem dividends, which are not reported on the estate tax return, but are reportable income on the beneficiaries' income tax returns. You should give copies of the Forms 712 to Sally Smith so she can give them to her accountant and you should also give copies to the person who prepares your Form 1040.

? You should check the ownership of the policy as listed on the Form 712 against the ownership as indicated by the policy and any amendments or transfers in your possession. If the policy is actually owned by someone other than your father and the policy was transferred by your father at least 3 years prior to death, then the policy will not be included in the estate and subject to federal estate taxes. You should not rely on the Form 712 alone because sometimes a Form 712 is incorrect and it is up to you to confirm that the Form 712 is accurate.

? The policy paid to the partnership should be included in calculating the value of the partnership.

Schedule F - Other Miscellaneous Property

? The instructions to Schedule F state,

> "If the decedent owned any interest in a partnership or unincorporated business, attach a statement of assets and liabilities for the valuation date and for the 5 years before the valuation date. Also attach statements of the net earnings for the same 5 years. You must account for goodwill in the valuation. In general, furnish the same information and follow the methods used to value close corporations. See the instructions for Schedule B."

It will probably be sufficient if we attached the Schedule K- 1's. We have the K-1 for the years 2002 and 2001. Please provide the K-1 for the years 2000, 1999 and 1998.

? It will probably be sufficient if we attach the valuation report prepared by Allover Place Appraisers.

? For the partnerships we have not included the requested information. The return supply explains the values. If the return is audited we may be requested to provide the information requested in the instructions.

? Your father's interest in the life estate is listed. You need to sufficiently convince yourself that the property considered to be part of the life estate is properly accounted for and the life estate does not include property that properly is included in his taxable estate. Also, make sure that we have sufficiently accounted for income earned prior to death but not distributed until after death.

? The furniture and the jewelry are based upon the appraisals.

? The value of the household goods is based upon your best estimate of its value.

? The overpayment of 2002 individual income tax is included because as best as I can determine the payment of 2002 taxes came from overpayment of taxes in 2001, so all payments were made prior to the date of death.

Schedule J Expenses

? Certain expenses of administration can be deducted either on the Form 706 or on the Estate's income tax return, but not on both. Because estate tax is imposed at a higher marginal rate than the income tax, generally there is a strong incentive to deduct all administration expenses on the Form 706.

? Certain expenses of administration can be deducted either on the Form 706 or on the Estate's income tax return, but not on both. Because no tax is due on the Form 706 there is an incentive to forego the deduction on the Form 706 and deduct the administration expenses on the income tax return. An income tax deduction, however, has the effect of reducing the amount of the John Q. Sample Family Trust covered by the unified credit. Reducing the amount of the John Q. Sample Family Trust covered by the unified credit means that more property will be subject to estate taxes in your mother's Estate. It boils down to whether you want an income tax deduction at this time at your top marginal income tax rate or a future estate tax deduction at possibly 49%.

We show some of the deductions as deductions on the Form 706 and some we do not. Attorneys fees and accountants fees can be deducted on either return. Please let us know on which return you want to deduct the attorneys fees, accountants fees, and other expenses of administration. If you are unsure, we can go through the different calculations with you.

? The return does not include an amount for executor's commissions. Any amount paid to you as the executor is deductible for federal estate or income tax purposes by the estate, but will be subject to income taxes by you. If your income tax rate is 25% then there may be an economic benefit to taking a deduction on the estate tax return and paying income taxes on that amount. The will does not contain a provision stating what the executor's fees should be. In the absence of a provision on fees, the Texas Probate Code applies. Under the Code, you are entitled to receive a fee equal to 5% of funds received (except for cash in bank accounts) and 5% of the amounts paid out of the Estate (with the exception of distributions to the beneficiaries). As an example, you will be entitled to 5% on every security sold by the Estate and 5% on estate taxes paid by the Estate. You are also permitted to obtain additional fees with court approval if the work required on the Estate is not adequately compensated by the above fee. This alternative fee, however, cannot exceed 5% of the gross estate. If you will like to take a fee on the estate tax return, please let me know and we will help you determine an appropriate fee and include that on the return.

? We include a deduction for reimbursements, but we should have documentation of actual expenses to back up this deduction.

? We include a deduction for reimbursements, based on the documentation that you gave us.

? If you wish to be reimbursed for your expenses, simply run a list of those expenses and then write yourself a check. Give that information to your accountant so she can include that as an administration expense on the Estate's income tax return.

Schedule K, Part 1 Debts Of The Decedent

? Items listed here may also be deductible for income tax purposes. An example would be property taxes.

? We do not have a statement for the property taxes on the property for 2003. Those taxes can be deducted on both the estate tax and the income tax returns.

Return Due Date

There are two separate deadlines that you must contend with in administering the estate. One is the nine month deadline for disclaimers and the second is the nine month deadline for filing the federal estate tax return.

Disclaimers must be signed within nine months of the date of death. The law does not permit any extension on this nine month period. We were somewhat rushed in administering this Estate in order to determine how the family wanted to handle the bank accounts and whether funds should be disclaimed. As a result of preparing the estate tax return, we have an idea of what disclaimers your mother should sign. Your mother should proceed to

sign the disclaimer at this time while she is still capable of doing so. The disclaimer can be held until the nine month deadline approaches.

There is also a nine month deadline for filing a federal estate tax return, but that deadline can be extended for an additional six months. Normally, we do not file an estate tax return until it is due. Even though the estate tax return might be prepared months in advance of its due date, it is possible that additional assets may be discovered or additional debts and expenses result prior to the due date. Also, the filing of the estate tax return involves certain elections that cannot be made with full information until the due date approaches. Sometimes the tax elections are mutually exclusive; electing one tax treatment forecloses you from electing another tax treatment. The factors that indicate the election to take become more determined over time. For example, there are certain advantages in having property taxed in two estates rather than having it taxed in just one estate. If your parents should pass away close in time, there are tax advantages to incurring some tax in your father's Estate as opposed to delaying it all until your mother passes away. This decision is best delayed to the last possible moment, and for that reason we normally do not file until the nine months have passed.

This should not leave things uncertain, which can still cause stress for your mother. You can decide how you want to file and simply hold the filing until nine months so that if there is a change in your situation, the return can be changed.

My recommendation is that we let the estate tax return lie until the filing date for the return approaches, The only thing that we should do is have your mother sign the disclaimer, but hold on to it until the deadline of the disclaimer approaches, and sign a codicil to equalize gifts.

The Final Return

? Please let me know if you have any changes or comments. After you let us know about any changes or comments, then we will prepare the final copy of the Form 706 for your signature.

You might also wish to have the return reviewed by the accountant prior to its being filed.

The Form 706 must be filed by due date, so your prompt attention to this matter will be appreciated.

? If you do not have any changes or comments, please sign the return on the line indicated and return it to us by overnight mail.

? Because we have not had adequate time to review the valuation report, we recommend that the filing of an extension and the payment of tax based upon the information that we have to date. We have prepared for you an extension for your review and signature.

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APPENDIX B
Sample Engagement Letter

December 7, 2003

Mr. Richard V. Sample
1313 Ruele
San Antonio, Texas 78299

Mr. Harry J. Sample
123 Anystreet
San Antonio, Texas 78209

Re: Engagement Letter - Legal Fees and Expenses for Probating a Will, Preparing Form 706, and Administering an Estate

Dear Richard and Harry:

You are named as the Independent Co-Executors in the Will of John Q. Sample. As the person named as Independent Co-Executors, it is your responsibility to submit the will to a probate court for its ruling that the will is valid (called "probating the will"). If appointed Independent Co-Executors it will be your responsibility to collect the decedent's assets, pay his debts, file any necessary tax returns, pay the taxes, and distribute the estate to the proper beneficiaries (called "administering the estate"). You desire to retain the law firm of [LAWFIRM] of San Antonio, Texas (the "firm"), to represent you in probating the will and administering the estate.

The purpose of this letter is to summarize and confirm the terms and conditions of our understanding regarding [LAWFIRM]'s assisting as legal counsel for you in connection with the matters described in this letter.

The following discussion is necessary when representing more than one person.

Representing Multiple Clients

A lawyer has the duty to exercise independent professional, judgment on behalf of each client. When a lawyer is requested to represent multiple clients in the same matter, he can do so if he concludes that he can fulfill this duty with regard to each of the clients on an impartial basis and obtains the consent of each client after an explanation of the possible risks involved in the multiple representation situation. Further, if at any time during the representation it is determined that, because of differences between the joint clients, a lawyer can no longer represent each of the clients impartially, then the lawyer must at that time withdraw from representing all of the clients.

Each of you have the right to obtain separate legal counsel to represent you in all matters relating to this matter. Based on our understanding of your situation, we conclude that we can represent each of you on an impartial basis. In determining whether you should consent to this joint representation, however, you should carefully consider the following matters.

The first matter involves the attorney-client privilege. We believe that any information disclosed by you to us in connection with this representation will not be protected by the privilege in a subsequent legal proceeding asserted by or against one of you involving another of you. Moreover, we believe we cannot effectively represent each of you if information disclosed to us by one of you must be preserved by us in confidence from the other. If we are to represent you, it will only be with the express understanding that each of you has waived the attorney client privilege to the extent, but only to the extent, that the privilege might otherwise require us to preserve in confidence information disclosed by one of you to us from another of you.

If any of you divulge information to anyone except the other clients or members of our firm, the privilege would probably be waived, at least in part. The extent of that loss is not clear. It might relate only to the actual content of the specific communication. It could, however, involve related information.

Second, at this time there does not appear to be any difference of opinion among any of you with regard to the major issues involved in this matter. However, it may turn out, upon further consultation, that one or more of you may have varying opinions with respect to the matter for which we have been retained. It is our duty to explore each of these issues with you. Should we determine that there are material differences between you on one or

more of these issues that cannot be resolved on an amicable basis or that we conclude cannot be resolved on terms compatible with the best interests of each party involved, then we must at that time withdraw from the representation. If this occurs, we will, if you wish, assist each of you in obtaining new counsel. You would be responsible for payment of all our accrued legal fees and any outstanding expenses we have advanced on your behalf.

Include if representing one executor.

Conflicts Of Interest

It is not unusual in the administration of an Estate for one or more conflicts of interest to develop not only between the Independent Executor of the Estate and the Estate, but also for legal counsel in its representation of the Independent Executor as it relates to the Decedent's Estate. If and when any such conflicts may arise, we have a duty to notify one another of such conflicts.

Description of Services

Our firm agrees to represent you in probating the will and administering the estate. Our representation will include preparation and filing of the Form 706, United States Estate Tax Return, and required state inheritance and estate tax returns. The Form 706 is due {due date}, which is nine months after the date of death. We will perform such services as may be necessary to completely discharge our responsibilities as to these matters, as set forth in this letter.

As your counsel, you should note that we do not make any representation or take any responsibility for any other matter not specifically entrusted to us.

We will represent you in your capacity as Independent Co-Executors named in the Will and we will not represent you individually nor represent individually the beneficiaries named in the will. After you are appointed as the Executors we will assist you in notifying the beneficiaries that we represent you in your capacity as Independent Co-Executors and that we do not represent them as beneficiaries.

It is understood that we are representing you in a non-contested matter and if there is a contest filed in the proceedings, then we will need to reach another understanding regarding our representation of the estate.

It is our customary practice to keep our clients informed, at all times, of the status of the matters entrusted to us. In that regard, we will furnish you with the information concerning the work that we have performed on your behalf and the progress we are making in connection with the matters you have entrusted to us.

Include a description of any service that may involve action by a beneficiary, but exclude representation of those beneficiaries.

Our firm will also prepare and discuss with the family a disclaimer of interests passing through the joint bank accounts so the Family Trust established under the will is more fully funded. In doing so, we will still represent you as the Independent Co-Executors and we will not be representing those who may be asked to disclaim.

Services Not Included in Our Representation

It is understood that the firm is being retained by you to provide legal services. We have not been retained, and expressly disclaim any engagement, to provide business or investment advice, bookkeeping services, safekeeping of assets, or income tax return preparation.

You are required to sign the Form 706, which contains a statement saying "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." While we will sign the return as preparers, in preparing the Form 706, we of necessity must rely on the information you provide to us. Thus, it is your responsibility to make sure the information contained on the Form 706 is complete and accurate to the best of your knowledge.

In the course of preparing the Form 706, we will use or refer to documents prepared by others, including but not limited to, deeds, legal descriptions of real property, agreements, registrations, financial statements, tax returns, bank statements and certificates. Even though we may use information contained in such documents prepared by others or use the documents themselves, you should not take such use to be an opinion as to the accuracy or legal effectiveness of such documents. If you want us to review and be responsible for the accuracy and legal effectiveness of documents prepared by others, then that needs to be included in a new written

engagement letter. Under our current engagement, our firm is not engaged to review for the general accuracy of, nor is it responsible for the legal effectiveness of, documents prepared by others.

The firm does not guarantee the outcome or results of any probate court proceedings.

This representation does not include other matters that are normally considered to be legal services, but which are not entrusted to us under this representation. Some of the items not included in this representation are:

(1) The review of any income tax returns prepared by another.

(2) Tax advice for the beneficiaries of the estate.

Any of these matters can be the subject of an additional representation by our firm, provided we discuss the representation and enter into a written agreement covering that representation.

Texas Lawyer's Creed

We are required to advise you of the existence of and our obligations under the Texas Lawyer's Creed. A copy of the Creed is set forth in Attachment A.

Personnel

Glen A. Yale, a shareholder in the firm will be primarily responsible for performing your work. Mr. Yale is Board Certified by the Texas Board of Legal Specialization in estate planning and probate law and is a fellow of the American College of Trust and Estate Counsel. If necessary, we may assign other attorneys who work with Mr. Yale to assist on this matter.

In having the firm represent you as legal counsel, you should understand that we must reserve the right to utilize any individual attorney in the representation. This is intended to be for your benefit. The determination of the attorney utilized for any particular task will be made with regard to his or her expertise, experience, time availability and considerations related to minimizing your costs consistent with the requirements of the engagement.

Required Notifications

We must notify you of your rights regarding suspected professional misconduct (see Attachment B) and regarding confidentiality of your information (see Attachment C).

Fees

The nature, character, and amount of fees charged by our law firm are determined in accordance with Rule 1.04 of the Texas Disciplinary Rules of Professional Conduct as adopted by the Supreme Court of Texas and the State Bar of Texas. Our fees, retainer, and payment policies are based upon the factors set forth in Attachment D.

Our legal fees for this representation will be based upon the actual time spent and the rate of the person providing the service. Time is recorded in 1/10th hour increments. Rates are influenced by the factors outlined above, and normally, the rates charged vary from $100 to $380 per hour for attorney's time and $55 to $75 per hour for law clerks' and legal assistants' time.

The firm bills separately for all expenses normally associated with legal matters including, postage, copies, filing fees, long distance telephone calls, and other necessary expenses.

We will generally submit monthly fee statements to you. It is agreed that any fees and/or expenses due under this letter are due upon receipt of the statement for such fees and/or expenses. Pursuant to Opinion 409 of the Committee on Professional Ethics, State Bar of Texas, all invoices outstanding more than 30 days will accrue interest at 1% per month from the date of invoice. If you have any questions regarding any fee statement, you may contact Glen A. Yale, (210) 229-3000.

Retainer

We will require an initial retainer in the amount of $5,000 before we commence our engagement. The retainer is refundable to the extent of any amounts remaining after payment of fees and expenses. These funds will be placed in our trust account with the interest accruing to the Texas Equal Access to Justice Foundation, a non-profit foundation supplying civil legal services to people not otherwise able to afford such services. The retainers will be applied to your legal fees when you are billed for our services and the expenses and any amounts not

applied to our fees will be refunded to you when our engagement is completed or terminated. This retainer will be kept in our firm's trust account and drawn upon based on services performed and expenses incurred. You will receive a report on your trust account every month in which there is trust activity; otherwise, the trust account record will be mailed to you quarterly by our accounting department.

Termination

You shall at all times have the right to terminate our services upon written notice to that effect.

It is further understood that our representation of you in this matter will cease upon your no longer serving as Independent Co-Executors, upon completion of the administration of the estate, or upon completion of all matters specifically entrusted to us under this agreement, whichever comes first.

In addition to any other circumstances that will require our withdrawal from representation, we reserve the right, at our option, to withdraw from this engagement in the event any invoice remains unpaid or if we determine in our reasonable discretion that to continue our firm services to you would be unethical or impractical.

Arbitration

Any dispute arising under this engagement agreement and/or the services rendered for you by our firm will be submitted to arbitration in San Antonio, Texas, by the Fee Dispute Committee, of the San Antonio Bar Association, if concerning fees, or to arbitration by an arbitrator to be named by a United States District Judge for the Western District of Texas, San Antonio Division, if concerning any other matter. The decision of the Fee Dispute Committee or any such arbitrator shall be binding conclusive and nonappealable.

Law Applicable

This agreement and its performance are governed by Texas law.

CONCLUSION AND SIGNING OF ENGAGEMENT LETTER

We want you to be satisfied with the terms of the representation and understand them fully before signing this agreement. Please also note that we welcome inquiries that aid us in maintaining your confidence in our firm. Once again, we appreciate the opportunity to work with you on this important endeavor.

If this letter's terms and conditions accurately summarize and confirm your understanding of our engagement, please indicate your approval and acceptance by dating, signing, and returning this letter in the enclosed self-addressed, stamped envelope together with your check in the amount of $5,000, made payable to our law firm. Enclosed for your records is a copy of this letter signed on behalf of the law firm. Upon your signing this letter and paying the initial retainer, we shall begin our representation.

By signing this letter you understand and agree to these terms as the Independent Co-Executors of the Estate.

Very truly yours,

[LAWFIRM]

By: _____

[ATTORNEY]

AGREEMENT TO TERMS AND JOINT REPRESENTATION

We each reviewed the foregoing letter. We understand the terms and agree to them. Each of us realizes that there are areas where our interests and objectives may differ and areas of potential or actual conflict of interest between us in connection with this representation. We understand that any of us may retain separate, independent counsel in connection with these matters at any time. After careful consideration, each of us requests that [LAWFIRM] represent us jointly in connection with this representation and each of us consents to that dual

representation. In light of the forgoing, each of us also understands and agrees that communications and information [LAWFIRM] receives from either of us relating to these matters may be shared with the others. This agreement shall become effective when all parties have signed below in multiple counterparts.

RICHARD V. SAMPLE	HARRY J. SAMPLE

ATTACHMENT A --*TEXAS LAWYER'S CREED*

We are required to advise you of the existence of and our- obligations under the Texas Lawyer's Creed A copy of the Creed is enclosed along with this letter Pursuant to the Creed, we advise you that:

1. *Proper and expected behavior of counsel are described in the Creed.*
2. *Civility and courtesy are expected, from lawyers and are not a sign of weakness.*
3. *We will not pursue conduct which is intended primarily to harass or drain the financial resources of the opposing party.*
4. *We will not pursue tactics which are intended primarily for delay.*
5. *We will not pursue any course of action which is without merit*
6. *We reserve the right to determine whether to grant accommodations to opposing counsel in all matters that do not adversely affect your lawful objective.*
7. *You are advised that mediation, arbitration and other alternative methods of resolving and settling disputes are available to you to resolve disputes with opposing parties.*

ATTACHMENT B

NOTICE TO CLIENTS

The State Bar of Texas investigates and prosecutes professional misconduct committed by Texas attorneys.

Although not every complaint against or dispute with a lawyer involves professional misconduct, the State Bar Office of General Counsel will provide you with information about how to file a complaint.

For more information, please call 1/800/932/1900. This is a toll free call.

ATTACHMENT C -- PRIVACY POLICY

Attorneys, like other professionals who advise on personal financial matters, are now required by the Gramm-Leach-Bliley Act to inform their clients of their policies regarding privacy of client information. Attorneys have been and continue to be bound by professional standards of confidentiality that are even more stringent than those required by this new law. Therefore, we have always protected your right to privacy.

In the course of providing our clients with income tax, estate tax, and gift tax advice, we receive significant personal financial information from our clients. If you are a client of Howers & Billings Inc., you should know that all information that we receive from you is held in confidence, and is not released to people outside the firm, except as agreed to by you, or as required under an applicable law.

We retain records relating to professional services that we provide so that we are better able to assist you with your professional needs and, in some cases, to comply with professional guidelines In order to guard your nonpublic personal information, we maintain physical, electronic, and procedural safeguards that comply with our professional standards.

ATTACHMENT D -- *FACTORS UPON WHICH FEES, RETAINER AND PAYMENT POLICIES ARE BASED*

1. *The fume and labor required, the novelty and difficulty of questions involved, and the skill requisite to perform the legal service properly;*
2. *The likelihood that the acceptance of the particular employment will preclude oth er employment by the firm or any of 'its lawyers;*
3. *The fee customarily charged in this locality for similar legal services;*
4. *Time amount involved and the results obtained;*
5. *The time limitations imposed by, you or by the circumstances of our engagement;*

6. *Time nature and length of our professional relationship with you;*
7. *The experience, reputation and ability of the lawyer or lawyers performing the services; and*
8. *Whether the fee is fixed or contingent on results obtained or uncertainty of collection before legal services have been rendered.*

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Warning:
May Not Comply With Circular 230 After June 20, 2005

APPENDIX C
Obtaining Information to Complete the Form 706

One of an estate planning attorney's responsibilities is to educate the personal representative of a decedent's estate on the personal representative's responsibilities. This is especially true for the personal representative's responsibilities to provide information as to the decedent's property, because the attorney will rely upon the information provided by the personal representative. To make sure the personal representative is informed of the responsibility to provide complete information, we provide personal representatives with a copy of the Form 706 along with our commentary on the type of information we are seeking.

Our commentary is printed on the back side of the Form 706 pages, so the information is available on the left side while the booklet is open to the relevant page of the return. For example, when Schedule C is open on the right side, the explanation for that schedule is open on the left side, the backside of Schedule B. On some pages, the size of the type is reduced so all of the explanation can be squeezed onto one page. For each explanation, the page on which it is printed is indicated.

This is an excellent tool to place your disclosures and discussions in the client's hands. We walk the client through the Form 706 and discuss the various information that we are seeking as well as obtain a preliminary idea of the property that the decedent owned. As we move through the return, we can highlight or circle information or questions that are critical to proper preparation of the return.

Some of the information that we solicit will be based upon the particular situation, and the commentary can be personalized. In this sample commentary, we refer to the decedent by his relationship to the personal representative; here the personal representative's father. In Texas, the personal representative is usually an independent executor or independent executrix, so we use the proper title. In this sample, we also refer to the fact that the executor's father was survived by his wife, who was not the executor's mother. There will be a marital deduction but there will also be a tax liability. The footnotes in the commentary provide usual information for the readers of this article and do not constitute part of the commentary given to the client

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[Title page backside]

FORM 706, PAGE I

One of your most important responsibilities as Independent Executor of the Estate of your father (your father will sometimes be referred to as the "decedent") is the filing of the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. You must file the return within nine months after the date of your father's death, unless an extension to file is granted.

You are required to sign the Form 706, which contains a statement saying "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." While we will sign the return as preparers, in preparing the Form 706, we of necessity must rely on the information you provide to us. Thus, it is your responsibility to make sure the information contained on the Form 706 is complete and accurate to the best of your knowledge.

In preparing the Form 706, we will use or refer to documents prepared by others, including but not limited to, deeds, legal descriptions of real property, agreements, registrations, financial statements, tax returns, bank statements and certificates. Even though we may use information contained in such documents prepared by others or use the documents themselves, you should not take such use to be an opinion as to the accuracy or legal effectiveness of such documents. If you want us to review and be responsible for the accuracy and legal effectiveness of documents prepared by others, then that engagement needs to be included in a new written engagement letter. Under our current engagement, our firm is not engaged to review for the general accuracy of, nor is it responsible for the legal effectiveness of, documents prepared by others. [This language is repeated in the engagement letter.]

Some of the information that must be reported is obvious from the requests made on the Form 706. Some of the questions on the Form 706 are not as clear and an explanation of the request may help your understanding. All references to Sections in this memorandum are to Sections in the Internal Revenue Code.

Questions la Through 7b. Items 9 through 7b are general information on the decedent and the personal representative of the Estate

? *You need to supply us with the year your father moved to San Antonio and established the city as his permanent address. Domicile does not mean how many years he lived at a particular address, but refers to* number of years spent in a locality.

? *We need two death certificates to attach to the return.*

Question 9, The Form 4768 referred to in question 9 is an extension to the time to file the tax return. The tax return is due nine months after the date of death, which means it is due October 1, 2003. [This assumes DOD of January 1, 2003.] You must pay the estimated tax due by that date and may request an extension of up to six months to complete and file the actual return.

Question 10. Schedule R-1 refers to certain types of generation-skipping transfers. Whether there are any such transfers in the Estate will be determined at a later date.

Computational Provisions. Items 1 through 25 of the computation provisions of Page 1 will be transferred to this page from other pages of the Form 706. We will make these computations after the Schedules are completed.

[Page 1 backside]

FORM 706, PAGE 2

Part 3, Question 1, Alternate Valuation. You can elect to value the assets in the Estate using the alternate valuation date. Normally all property must be valued as of the date of death. The alternate valuation date is (i) the date the property is distributed, sold, exchanged or otherwise disposed of within six months of the date of death or (ii) six months after the date of death for all other property not distributed, sold, exchanged, or otherwise disposed of within six months. Alternate valuation is important if tax is due on the Form 706, and the value of the property significantly decreased from the date of death until the alternate valuation date. Once the Form 706 is filed, the alternate valuation election is final. Alternate valuation does not mean we should wait until six months from your father's death to start the valuation process. Instead we should start immediately collecting the information necessary to value the assets in the Estate. During the course of the administration, it will be decided whether to use the alternate valuation procedure. Alternate valuation can only be used if there is a decrease in the value of the entire Estate, and if used it must be used for all assets of the Estate.

Part 3, Question 2, Special Use Valuation. A farm or closely held business can be valued at its farm or business use value rather than its fair market value. This is called special use value. The requirements for taking advantage of special use valuation are very detailed and rigorous. However, the benchmark for determining whether special use valuation should be considered is if 50% or more of the adjusted value of the Estate consists of a farm or closely held business property. If you think special use valuation may be applicable, request a copy of the article "Special Use Valuation: Saving Estate Taxes of Farms, Ranches, and Closely Held Business." [This is a separate article that we make available to our clients.]

Part 3, Question 3, Pay Taxes In Installments. Under certain circumstances tax due to a closely held business can be deferred. We will determine if this provision applies to this estate after the Schedules are completed.

Part 3, Question 4, Defer Taxes On Reversionary or Remainder Interest. If your father owned a remainder interest in property after a life estate or term of years held by another person, then the value of such remainder interest must be included in the Estate at its fair market value. The Estate can elect to pay the taxes after the life estate or the term of years terminates.

? *You need to inform us whether your father held a remainder interest in any property or trust.*

Part 4, In General. The first portion of Part 4 lists the person you, as the personal representative of the Estate, authorize to receive confidential tax information from the IRS.

Part 4, Item 2. Under Item 2, a general description of your father's business or occupation must be stated and it must be indicated whether or not he was retired.

Part 4, Questions 3 and 4, Marital status. Questions 3 and 4 concern your father's marital status.

Part 4, Question 5, Other beneficiaries of estate. If there are any beneficiaries of the Estate (other than charitable organizations) who receive more than $5,000, these persons must be listed in the schedule under Question 5. This includes any trusts to be established under the Will. Identifying number refers to social security number or federal identification number. For the trusts created under the Will, it is not necessary to obtain a federal identification number until the trusts are actually funded, which in most cases will be after the date the Form 706 is fled. The value of the property passing to each of the beneficiaries under Question 5 cannot be determined until all the values for the estate are known. Disclaimers may change the beneficiaries listed here.

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Part 4, **Question 6, Section 2044 Property.** Section 2044 property is property for which a previous qualified terminable interest property (QTIP) marital deduction election was made, either under the estate tax or gift tax rules.

The trust your father was a beneficiary of was a QTIP trust, and the full fair market value of the trust is included in this Estate and is subject to estate taxes.

Part 4, Question 7, **Federal Gift Tax Returns.** If your father made any gifts after December 31, 1981, to persons other than his wife, and the total amount of present interest gifts in any one calendar year to any one person exceeded $10,000 ($11,000 in 2002) then it was necessary to file a gift tax return to report the gifts. It is also necessary to file a gift tax return if a gift of a future interest in any amount was given. The gifts may not be taxable, but the gift may reduce the amount of the unified credit against estate and gift taxes and thereby affect the amount which can pass tax free in your father's estate. If your father ever fled any gift tax returns, then we need to report this on the Form 706. *If no returns were filed, but gift tax returns should have been filed, then it is your responsibility* as *Independent Executor to file the returns.*

If you are uncertain whether gift tax returns were filed, let us know and we will prepare a request to the IRS to see if they have a copy of any returns.

Part 4, Question 10, Closely Held Business. This question must be answered yes if any one of four situations is true. (1) If your father owned an interest in a partnership, regardless of whether the partnership was subject to a written or an oral agreement, then the answer is yes. (2) If your father had an interest in a sole proprietorship, then the answer is yes. (3) If your father owned stock in a closely held corporation, then the answer is yes. (4) The answer is also yes, if your father had an interest in an inactive corporation.

Part 4, Question 11, Certain Transfers. See explanation under Schedules G and H.

[After Page 3, frontside]

Part 4, Question 12a, Trusts. If your father created any trusts during his life and such trusts were in existence at the time of his death, then the answer to this question is *yes*. If your father transferred property to a trust, even if he was not named as the grantor on the trust agreement, then your father may be treated as a creator of the trust for purposes of this question. If your father created any trusts and such trusts were in existence at the time of his death, copies of the trust agreements must be included as part of the Form 706.

? *Please let us know if you are aware of any trusts created by your father and provide us a copy.*

Part 4, Question 12b, Powers, Beneficial Interest, or Trusteeship. If your father was a beneficiary of any trust, either currently or contingently, then the answer to this question is yes. Also, the answer to this question is yes if your father was serving as trustee of any trust at the time of his death. This question only applies to trusts as to which the grantor was someone other than your father. If this question is answered yes, then a copy of the trust agreement must be included as a part of the Form 706.

? *Please let us know if your father was the beneficiary or trustee of any trust.*

Part 4, Question 13. What constitutes a general power of appointment is discussed at Schedule H.

Part 4, Question 14. Your father's will was dated after September 12, 1981, so the ERTA transitional rule (for wills executed before 1982) does not apply and the answer is no.

Part 4, Question 15, Annuity. If your father was receiving a certain type of annuity, then the answer to this question would be yes, and the annuity would have to be reported. See the explanation under Schedule I for more information regarding the types of annuities that need to be reported.

? *Please let us know if your father was receiving any annuities.*

Part 4, Question 16. This question is designed to alert the IRS whether the Estate is not including property that was previously deducted as QTIP property on a previous gift tax or estate tax return of your father's wife.

THE SCHEDULES

The remainder of the Form 706 requests information on the property included in the Estate. As the Independent Executor you are responsible for determining the assets in the Estate. The listing of the property must be complete. We are relying on you for the information, but we will assist you in determining what information should be reported. There are two elements to each item. First, there is an accurate description of the item. Second, each item must be appropriately valued. Because your father was married on his date of death, there is a third element: whether the property is community property, your father's separate property, or his wife's separate property.

In addition, the following schedules will report the liabilities of the Estate as well as the expenses incurred in administering the Estate. As with assets of the Estate, these items must be properly determined and the amounts claimed as liabilities and expenses properly documented.

There are penalties for underpayment of estate taxes of $1,000 or more that are attributable to valuation understatements. Therefore, you will want to report as the fair market value an amount that is reasonable and that can be supported.

The values on this Form 706 can be used to establish the basis of the property. If an asset in the Estate is subsequently sold, the value on this Form 706 will probably be used for determining capital gains and losses for income tax purposes.

[After page 3, backside]

SCHEDULE A - REAL ESTATE

Schedule A must include any real estate which your father owned, or had contracted to purchase, at the time of his death. Real estate which is owned by business entities such as partnerships and corporations would not be shown on Schedule A.

Examples of real estate which would be included on Schedule A are interests in the residence, ranches, farms, condominiums, or cooperatives. Also, certain mineral interests are considered to be real estate and would also be reported on Schedule A.

The description needed for each piece of real property is the legal description set forth in the deed or any other instrument of conveyance. Ad valorem tax statements usually contain a legal description that is sufficient for an estate tax return. If the property is in the city and is an item such as a residence, then the street address will also be included in the description. A full legal description is needed to prepare any deeds transferring the real estate when it is distributed from the Estate.

The value of real property listed on Schedule A is usually determined by one of these means: (i) a formal appraisal, (ii) the value on the ad valorem tax statements, or (iii) the sales *price if the real property is sold* before *the return is filed.* The ad valorem tax statement for the property is used as a starting point for valuation purposes. Since property is not usually appraised for ad valorem tax purposes by the taxing authorities on a current basis, to achieve certain post-mortem estate planning objectives an appraisal may be necessary. It can be especially important to obtain appraisals in a depressed real estate market because appraised values may be significantly lower than the values for ad valorem purposes. The appraisals can also be used to reduce the value of the property for ad valorem purposes. We will assist you in finding a competent appraiser if it is determined, after a review of

your father's interests in real estate, that appraisals will aid in the overall estate planning objectives.

Significant mineral interests will require a special type of mineral appraisal.

Real property titled in your father's name and located outside of Texas may require ancillary probate proceedings.

? We will need a legal description of your father's residence The legal description is usually contained in the deed by which your father obtained the property.

? Please provide us with a list of any other property owned by your father, including the legal description and approximate values of such property.

? Provide a copy of each deed that you can locate so we can confirm title and have the complete legal description.

Check your father's mail and his papers, because real property ownership usually results in an ad valorem tax statement.

[Schedule A backside]

SCHEDULE A-1 -SECTION 2032A VALUATION

A farm or real property used in a closely held business can be valued at its farm or business use value rather than its fair market value. This is called special use value. The requirements for taking advantage of special use valuation are very detailed and rigorous. However, the benchmark for determining whether special use valuation should be considered is if 50% or more of the adjusted value of the estate consists of a farm, ranch, or closely held business real property. If you think special use valuation may be applicable, request a copy of the article "Special Use Valuation: Saving Estate Taxes of Farms, Ranches, and Closely Held Business." [This is a separate article that we make available to our clients.]

[Schedule A-I backside]

SCHEDULE B - STOCK AND BONDS

Stocks to be included on Schedule B range from shares held in publicly traded corporations where there may be thousands of shareholders to shares held in closely held corporations where there may be only a few shareholders Stocks and bonds on Schedule B include interests in corporations and limited liability companies. Interests in partnerships are listed on Schedule F.

Check your father's current mail and papers for any dividends or interest on stocks and bonds.

As Independent Executor, you are responsible for determining which stocks and bonds are in the Estate and obtaining a sufficient description of such items.

We will help you in determining the value of the different stocks and bonds included in the Estate. The preferred way to obtain the value for publicly traded stocks and bonds is to give us the number of shares, if common or preferred stocks, or the face amount on the bonds and the stock or bond cusip number; and we will obtain the value for you using a valuation service.

? For any publicly traded stocks and bonds, please provide the number of share or the face amount on the bond and the stock or bond CUSIP number.

? For any accounts with brokerage firms, provide a copy of the statement that covers the date of death and a copy of the account agreement so we can determine how the account is owned.

If the stocks are closely held, then there will be no trading data which can be used to determine value. In this situation, in order to determine value we will need to examine and include with the Form 706 the full financial statements and income tax returns for the corporations for the past five years, we will need an exact description of the type of business and the assets included within such business in order to make comparisons to similar publicly traded corporations if possible, and we may need other information as determined on a case by case basis. We will

also need to know the percentage of ownership your father held in the closely held corporation, whether there were any restrictions on the transfers of shares, and whether there were any buy-sell agreements in place. This information is *needed so we can determine whether any adjustments to value need to be made for lack of marketability or control. If the Estate has any holdings in closely held business properties, then please let us know at the earliest possible time in order that we can determine the proper method for valuation.*

? Let us know if the Estate includes any closely held corporations.

? For any closely held corporations, provide both financial statements and income tax returns for the last five years.

[Schedule B, backside)

SCHEDULE C - MORTGAGES, NOTES, AND CASH

For each account your father had in financial institutions there must be listed the name and address of the financial institution, the amount in each account on the date of death, the account number, and the nature of such account (i.e., savings, checking, certificate of deposit, etc.).

? For accounts at financial institutions, it will be necessary to obtain a statement that covers the account on the date of death.

If such a statement is not available, then each financial institution must be sent a request to provide the balance as of the date of death in the form of a letter.

? For accounts at financial institutions, provide a copy of the signature card or account agreement so we can determine ownership.

If the return is audited, the tax examiner will request to see the canceled checks for the last three years. We like to review those canceled checks prior to filing the return, so we can address any obvious issues they raise.

? Please provide us your father's canceled checks for the last three years.

Frequently, bank accounts are not owned individually, but instead are owned jointly. See the instructions to Schedule E.

This Schedule also is to include any mortgages and notes payable to your father at the time of death. (Mortgages and notes payable by your father, if deductible, will be listed on Schedule K).

? For mortgages and notes payable to your father, you will need to provide a copy of the note. Also amortization schedules or any statement of current balance, if available, should be provided.

If your father had entered into a contract to sell land at the time of death, then this contract must be included as an asset of the Estate on Schedule C. (Schedule A includes property on which there is a contract to purchase.)

? Provide us with a copy of any earnest money contract to sell property.

For mortgages, notes, and contracts to sell land, a copy of such instruments must be attached to the Form 706 and such other information as is necessary to determine the value at the date of death.

You are also required to list the amount of cash on hand that your father had, such as the cash in his wallet or an emergency stash. Cash on hand also includes cash held in a home safe or a bank safe deposit box.

? *Please let us know the amount of cash on hand.*

[Schedule C backside]

SCHEDULE D - INSURANCE ON THE DECEDENT'S LIFE

Schedule D must include a list of every policy of life insurance on your father's life, whether or not included

in the Estate for federal estate tax purposes.

For every policy included on Schedule D, a Form 712, life insurance statement, must be obtained from the insurance company which issued the policy. If you let us know the insurance company and the policy number, we can request the Form 712 for you.

? *Please let us know the names of all insurance companies and the applicable policy numbers on all life insurance policies.*

Only insurance which is payable in favor of the Estate or in which your father owned any "incidents of ownership" is included in the Estate. If a policy does not meet these criteria, it must still be listed on the Form 706, but the value will be listed at zero. Incidents of ownership in a policy include the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, the power to pledge the policy for a loan, and the power to obtain from the insurer a loan against the surrender value of the policy. In addition, the policy could also be included in the Estate if your father transferred the insurance policy within three years of the date of death.

Polices in which your father did not have any "incidents of ownership" include policies on your father's life which were owned by others. Policies owned by others would include policies owned by any person other than your father individually and policies in irrevocable life insurance trusts.

? *Please let us know whether there were any policies owned* by *others or policies in an irrevocable life insurance trust.*

[Schedule D backside]

SCHEDULE E - JOINTLY OWNED PROPERTY

Part I - Joint Interest held by Decedent and Spouse.

Part 1 must be completed if your father owned with his wife any property as a joint tenant *with rights of survivorship.* If the property is jointly owned but without rights of survivorship, then the property is not reported on this schedule.

Part 2 - Other Joint Interests.

If your father owned any property as a joint interest with rights of survivorship where the other joint tenant is not his wife, then such interest must be included in Part 2. For example, if you were a joint owner along with your father in any account that had rights of survivorship, then such account would be listed on Part 2.

Generally, the presumption is that the full value of the jointly owned property is included in the gross estate. However, if it can be shown that each of the joint owners contributed a proportionate amount of the property in the joint account, then only that proportionate share is included on the Form 706.

The most common items owned as joint tenancies are accounts at financial institutions. You should obtain a copy of the signature card of each account at each financial institution. Copies of the signature cards can be obtained by contacting the financial institution and asking them to send you a copy of the documentation initially used to establish the account or any subsequent documentation which changed the signatories on the account.

? *Please send us a copy of the signature card or account agreement on all accounts in order that we can determine the ownership of the accounts.*

Real property can also be owned jointly with rights of survivorship, if that is what the deed provides. In that case, the real property is included in this schedule, but joint real property without rights of survivorship is listed on Schedule A.

? *Please provide a copy of every deed to real property. Stock brokerage accounts are sometimes held jointly.*

? *Please provide us a copy of the account agreement on all stock brokerage accounts.*

Joint ownership is important not just because it will determine the schedule on which it is reported, but also because the survivor named in joint ownership may be different than the person who would receive the property under the Will.

[Schedule E backside]

SCHEDULE F - OTHER MISCELLANEOUS PROPERTY NOT REPORTABLE UNDER ANY OTHER SCHEDULE

Schedule F must include all other assets in the Estate which are not reported on any other schedule. Such items would include debts owed to your father (other than notes and mortgages included on Schedule C), interests in unincorporated businesses, any insurance policies owned on the life of another person, any claims such as claims for damages in lawsuits, any royalties, any leaseholds, any judgments which may be received, any remainder interests, any interests in trusts, automobiles, and household goods and personal effects.

There are three questions on Schedule F which must be answered. If your father owned any fine art or any collections such as coin or gun collections which have a value in excess of $3,000, then such collection may need to be individually valued. The details of the collection would be reported on Schedule F, and it may be necessary to obtain an appraisal to properly value the items.

? Please let us know of any such fine art or collections so a determination can be made of whether an appraisal is necessary.

If your father received a death benefit from any company as a result of his death, then this question must be answered yes and the details supplied on the schedule.

If your father had a safe deposit box at the time of his death or had access to a safe deposit box, then this question must be answered yes. You must supply us with the location of the safe deposit box and whether such safe deposit box was held jointly with another. You must make a list of the contents of the safe deposit box in order to determine whether the property needs to be included in the Estate. If such property is not included in the Estate, an explanation must be included of why the property was not included.

If your father owned any interests in partnerships or unincorporated businesses, then the same information which is required for valuation of closely held business stock is also required to value such interest in such business entities. This would include, but is not limited to, financial statements and income tax returns for the past five years. We also need any written partnership agreements.

? For any partnerships, provide financial statements and income tax returns for the past five years and copies of any written partnership agreements.

? For automobiles which your father owned, we will need the make, the model, and the year of the automobile.

For household goods and miscellaneous contents, we can recommend an appraiser to determine the fair market value, based upon the nature of the household goods.

? Please discuss the appraisal of household goods and contents with us before you arrange for the appraisal. Jewelry is usually appraised by a jeweler.

? Please discuss the appraisal of jewelry with us before you arrange for the appraisal.

Other items we need to examine to determine whether there is any other property that needs to be reported in the Estate are copies of the last three Federal income tax returns which your father filed before his death.

? Provide copies of the last three Federal income tax returns filed by your father.

[Page after Schedule F]

In regards to Federal income taxes, a determination will need to be made regarding 2003 liability and/or prepayments. Refunds due your father will need to be included on this schedule and taxes due will be reported on Schedule K.

- When it is prepared, please provide a copy of your father's 2002 income tax return

On the page after Schedule F, you will find a list of property that must be included in the Estate if your father owned the listed item. [List adapted from RIA's Complete Guide: Federal Estate Tax Return, p. 112 (out of print).]

Checklist 7
Schedule F, Miscellaneous Property Checklist

- ❑ Accounts receivable
- ❑ Aircraft
- ❑ Airline frequent flier miles*
- ❑ Animal trophies*
- ❑ Antiques
- ❑ Art objects*
- ❑ Automobiles*
- ❑ Boats
- ❑ Bonus claims (see Salary)
- ❑ Books*
- ❑ Business interests (unincorporated)*
- ❑ Checks, unnegotiated*
- ❑ Claims*
- ❑ Clothing (see "wearing apparel")
- ❑ Coin collections*
- ❑ Collections, miscellaneous*
- ❑ Commissions, claims to
- ❑ Compensation, decedent's right to
- ❑ Computers*
- ❑ Contingent claims
- ❑ Contingent remainder, not extinguished by decedent's death
- ❑ Contraband*
- ❑ Co-partnership interest
- ❑ Copyrights
- ❑ Costumes (see "wearing apparel")
- ❑ Crops (growing at decedent's death)*
- ❑ Currency, collections
- ❑ Currency, foreign
- ❑ Debts due decedent (other than*mortgages and notes)
- ❑ Deferred compensation claims (see "Salary")
- ❑ Engravings
- ❑ Escrow accounts
- ❑ Estate income, accrued at decedent's death
- ❑ Estates, interest in*
- ❑ Etchings
- ❑ Farm machinery*
- ❑ Farm products and growing crops
- ❑ Fees, uncollected
- ❑ Fire insurance premiums prepaid for periods after death
- ❑ Firearms, guns, rifles
- ❑ Furnishings
- ❑ Furniture
- ❑ Furs
- ❑ Gemstones*
- ❑ Goodwill
- ❑ Horses, thoroughbred
- ❑ Household goods and personal effects*
- ❑ Individual retirement accounts (IRA)*
- ❑ Insurance Renewal Commissions*
- ❑ Intellectual Property*
- ❑ Interests in business
- ❑ Jewelry*
- ❑ Joint ventures
- ❑ Judgments*
- ❑ Lawsuits*
- ❑ Leaseholds not reportable as real estate on Schedule A
- ❑ Life estates*
- ❑ Life insurance (on life of person other than decedent)*
- ❑ Limited liability companies*
- ❑ Livestock*
- ❑ Loans (other than mortgages and notes)
- ❑ Lottery prizes*
- ❑ Marital deduction (Section 2044) property*
- ❑ Medical insurance reimbursement due decedent at death
- ❑ Musical instruments*
- ❑ Name, voice, signature and likeness*
- ❑ 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 in sole proprietorship*
- ❑ Receivables and refunds, miscellaneous
- ❑ Refunds, general*
- ❑ Remainder interests*
- ❑ Residuals
- ❑ Reversionary interests not reported as real estate on Schedule A
- ❑ Rights
- ❑ Royalties
- ❑ Salary*
- ❑ Sculpture
- ❑ Section 2044 property
- ❑ Security deposits
- ❑ Severance pay claims
- ❑ Silverware*
- ❑ Social Security benefits (see "Checks Unnegotiated")
- ❑ Sole proprietorships
- ❑ Sports memorabilia (see "Wearing apparel")
- ❑ Stamp collection
- ❑ Statuary
- ❑ Stock options*
- ❑ Tax refund claims*
- ❑ Trademarks
- ❑ Trade secrets
- ❑ Trust funds, shares in*
- ❑ Trust income accrued to decedent's death
- ❑ Trust interests
- ❑ Vases
- ❑ Wages (see "Salary")
- ❑ Wearing apparel*
- ❑ Yachts

Items marked by an asterisk (*) are discussed in this Chapter 10.

[Page after Schedule F backside]

SCHEDULE G - TRANSFER DURING DECEDENT'S LIFE

Schedule G is to include the value of any items your father transferred within the last three years of his life and concerns four situations, any one of which being true will require inclusion in the Estate.

1 First, if your father made a transfer described in Section 2035, then the property will be included in the Estate. Section 2035 transfers are mostly limited to (i) gifts by your father of life insurance policies on the life of your father within three years of death, or (ii) any federal gift taxes paid on gifts made by your father within three years of the date of his death.

2. Section 2036 refers to transfers in which your father retained the right to use the property. For example, if he sold or gave another the right to use property after his death, but retained the right to use the property or receive the income from it during his life, the property would be Section 2036 property and the entire fair market value of the property would be included in the Estate. The right to use the property can either be explicit or be implied. For example, if he gave another property, but there was an understanding that he could use the property anytime he wanted, the property is Section 2036 property and is included in the Estate.

3. Section 2037 includes transfers in which the final ownership of the property is not vested unless the beneficiary survives your father, and immediately prior to death there is a greater than 5% chance that the property can vest in your father. This provision is of concern only if your father made a transfer in trust, through a life estate, or by an irrevocable beneficiary designation.

4. Section 2038 includes transfers which are revocable or over which your father retained a power of appointment. Examples would include trusts created by your father in which he had the right to revoke the trust and vest all of the property in himself. Another example would be his creation of a power of appointment and reserving to himself the power to designate who will receive the property by exercising the power of appointment. If any one of these situations occur, then the property will be included in the Estate.

SCHEDULE H - POWERS OF APPOINTMENT

Schedule H is to include property over which your father had a general power of appointment, regardless of whether the power was exercised. A general power of appointment is any power or interest in a trust by which your father could vest the property in himself, in his creditors, in his Estate, or in the creditors of his Estate. If he has a power to appoint to someone other than himself, his creditors, his Estate, or the creditors of his Estate, then the power is a power of appointment, but not a general power of appointment. Property subject to such a special power would not be included in the Estate.

Another type of power of appointment that needs to be listed on Schedule H is a right to withdraw up to the greater of $5,000 or 5% of the value of the assets in a trust.

If your father ever had a general power of appointment, during his life or at the time of his death, then the Form 706 must include a copy of the instrument creating the general power.

? Please supply us with copies of all trust instruments or wills under which your father had an interest so we can determine if your father held a power of appointment, general or special, or had a right of withdrawal that requires property to be included in the Estate.

[SCHEDULES G AND H BACKSIDE]

SCHEDULE I -ANNUITIES

Schedule I will include any annuities or retirement plans (pension plans, 401(k), SEP, or IRAs owned by your father at the time of death. The term “annuity” includes one or more payments extending over a period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic.

An individual retirement account or individual retirement annuity will need to be listed on Schedule I if it provides for a series of substantially equal periodic payments to be made to a beneficiary for life or over a period

of at least 36 months after the date of death.

Your father's checking account register may indicate an annuity by a regular payment into the account.

? Please let us know whether your father owned any annuities or retirement plans (pension plans, 401(k), SEP, or IRA) at the time of his death.

(Schedule I backside)

SCHEDULE J - FUNERAL EXPENSES AND EXPENSES INCURRED IN ADMINISTERING PROPERTY SUBJECT TO CLAIMS

Funeral expenses may be deducted in full on the Form 706. You need to obtain copies of the invoices and copies of the checks paying the funeral expenses. Funeral expenses include any expenses for funeral home, clergy, music, headstones, burial, flowers, the traditional meal after the service and any other amounts spent on the funeral. The travel expenses of the chief mourner (usually the spouse or the oldest child) are also deductible if paid from the Estate.

? *Please provide us with the expenses associated with the funeral for your father.*

Administration expenses may also be deducted in full on the Form 706. Certain administration expenses, such as attorney's fees and executor's commissions, can be deducted either on the Form 706 or the estate's income tax return, but not on both. Once these amounts are determined and all of the other property in the estate has been valued, then we will discuss with you the advantages and disadvantages of deducting certain administration expenses on either the Form 706 or the Estate's income tax return.

As the Executor, you are entitled to compensation from the Estate, unless the Will prohibits a fee. In Texas, the compensation is generally figured at 5% of cash in and cash out of the Estate. If you do not intend to collect commissions, then no amount may be deducted on the Form 706.

Miscellaneous administration expenses may also be deducted. Miscellaneous administration expenses would include any costs of appraisals, insurance premiums paid to maintain insurance on estate property, costs to maintain property, any bank charges on estate bank accounts and a number of other items. All of these miscellaneous expenses must be supported by invoices and/or copies of canceled checks. In an estate where federal estate taxes will be paid, administration expenses serve to reduce the amount of tax due.

? *Please let us know of any deductible administration expenses.*

[Schedule J backside]

SCHEDULE K - DEBTS OF THE DECEDENT, AND MORTGAGES AND LIENS

Schedule K is divided into two parts - part one for claims of unsecured creditors and part two for claims of secured creditors. Since the debts of the decedent are reductions of the gross estate, it is important to identify all debts of your fathers which remain unpaid at the time of his death.

Any debts owed by your father at the time of his death can be deducted from the value of the gross estate on part one. Debts that can be deducted are unpaid income tax liability of your father at the time of his death, unpaid utility bills, unpaid credit card balances, and many other types of items.

Ad valorem taxes on real estate owned by your father may also be deducted. Based upon the real property owned by your father, we will further inquire as to the ad valorem taxes he owed at death.

Medical expenses of the last illness may either be deducted on Schedule K of the Form 706 or on the final Form 1040, individual income tax return.

Part two of Schedule K is where mortgages and liens payable by your father will be listed These secured debts are deductions from the gross estate, Such amounts would include any mortgages payable on principal residences, any mortgages on other parcels of real property which are recourse in nature, any tax or judicial liens which may have been levied against your father before his death, and any other type of secured claim, such as a loan on an automobile.

? Please inform us of all debts.

[Schedule K backside]

SCHEDULE L - NET LOSSES DURING ADMINISTRATION AND EXPENSES INCURRED IN ADMINISTERING PROPERTY NOT SUBJECT TO CLAIMS

If during the administration of the estate there are any losses from thefts, fires, storms, or other casualties, then to the extent not reimbursed by insurance the losses may be deducted on Schedule L.

Expenses incurred in the administration of a trust established by your father before death and expenses incurred in the collection or transfer of title of property that is included in your father's gross estate for federal estate tax purposes but not included in his probate estate may also be deducted. Types of property which may be involved in the last situation are life insurance policies and accounts which are joint tenancies with rights of survivorship.

[Schedule L backside]

SCHEDULE M - BEQUESTS TO SURVIVING SPOUSE

This schedule will be completed by us once all information has been gathered and the extent of the gift to your father's wife is known.

? For your father's wife, please provide us with her date of birth and whether she is a United States citizen.

? If your father's wife is a naturalized citizen, provide the date that she acquired citizenship.

? If your father's wife is not a United States citizen, please provide the country of her citizenship.

[Schedule M backside]

SCHEDULE O - CHARITABLE, PUBLIC, AND SIMILAR GIFTS AND BEQUESTS

For any real property or tangible personal property specifically given to a charitable organization, the appraisal requirements are not as critical because the property will not result in estate tax.

[Schedule 0 backside]

SCHEDULE P - CREDIT FOR FOREIGN DEATH TAXES

If your father owned any property outside of the United States at the time of his death, then such property may be subject to estate taxes in the foreign jurisdiction. If such property is subject to foreign death taxes, then a corresponding credit for death taxes paid may be allowed on the Form 706.

? Please let us know whether your father owned any property outside the United States.

SCHEDULE Q - CREDIT FOR TAX ON PRIOR TRANSFERS

If your father received property from a transferor who died within ten years before, or two years after, his death, a credit is allowed on the Form 706 for all or part of the federal estate tax paid by the transferor's estate with respect to the transfer.

? Let us know whether your father received any property by inheritance within the last ten years.

[Schedules P and Q backside]

SCHEDULE R - GENERATION-SKIPPING TRANSFER TAX

The generation-skipping transfer tax may be imposed in addition to estate taxes in certain situations. If a person upon death gives his child (or another similar generation) a life estate in property with the remainder passing to grandchildren, then a generation-skipping transfer tax will be imposed upon the life estate when the child dies. At the child's death, the generation-skipping transfer tax is imposed as an alternative tax since the life estate is not taxed in the child's estate and thereby escapes estate taxes.

Another form of generation-skipping transfer occurs when a grandparent makes a gift directly to a grandchild (or similar generation). Known as a direct skip, this form of transfer imposes a tax on a grandparent (the owner) upon the grandparent's death if made in a will.

A generation-skipping transfer is also made if your father's Will makes a gift to someone not related to him who is more than 37 and one-half years younger. Such gifts will require payment of tax or use of the generation-skipping transfer tax exemption.

? Request each beneficiary not related to your father to provide the date of his or her birth.

Every person has a $1,500,000 exemption from the generation-skipping transfer tax which may be applied during life or at death. The $1,500,000 exemption is an aggregate, not a per donee, exemption.

All generation-skipping transfers are reported on Schedule R and a decedent's remaining $1,500,000 exemption from the generation-skipping transfer tax is allocated on this schedule. There are generation-skipping transfers in the Will of your father and as far as we know your father still had all of his $1,500,000 exemption. Your father's Will sets up a Testamentary Trust. His generation-skipping tax exemption will be allocated to that Testamentary Trust, which is only to be funded with up to $1,000,000 or the amount of the unified credit for your father at the time of his death. Exemption may also be allocated to a QTIP marital deduction trust. There are advantages to dividing a QTIP marital deduction trust into two trusts, one with assets equal to the amount of exemption allocated and the other with assets that are not allocated exemption.

[Schedule R, page 3, backside]

SCHEDULE T - QUALIFIED FAMILY OWNED BUSINESS INTEREST DEDUCTION

The Estate may be entitled to a deduction and a reduced estate tax liability if your father owned an interest in a family-owned business. The requirements for the deduction are quite rigorous, and our analysis as to whether the deduction is available will begin with our review of the information you provide on any closely held businesses (see Schedule B).

[Schedule T backside]

SCHEDULE U - QUALIFIED CONSERVATION EASEMENT EXCLUSION

The Estate may obtain an exclusion if a qualified conservation easement was placed on real property by your father or by a member of his family. This exclusion is available for easements made after your father's death. To qualify for the exclusion, your father or a member of your father's family must have owned the land for at least three years prior to his death. Also, on the date of your father's death, the land must be located (i) within 25 miles of an area which is a metropolitan area, (ii) within 25 miles of an area which is a national park or wilderness area, or (iii) within 10 miles of an area which is an Urban National Forest. The easement must be for conservation purposes but cannot be for preservation of a historically important land area or a certified historic structure.

? Let us know if you believe the Estate will qualify for the conservation easement exclusion.

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APPENDIX D

Using Technology to Draft Estate Tax Returns

FORM 706 SOFTWARE

There are several considerations in choosing Form 706 preparation software:

Does the software have a program on the, font end that ,you use frequently enough so that the direct transfer of data into the 706 preparation program is a necessity or at least an advantage? Such a front end program may be an estate planning forecast program, a Form 709 preparation program, or a fiduciary accounting program. The convenience of transferability of data may not be important for all estates, but it could be important in a particular estate.

Does the software have a program on the back end that you use, frequently enough so that the direct transfer of information from the 706 preparation program into the other program is a necessity or at least an advantage? The back end program may be a fiduciary accounting program for preparation of the estate's Form 1041 or accounting reports for filing with the probate court. This will be important for professional firms that prepare Forms 1041 or are located in states where accountings are required, but will be of little or no benefit for firms that do not prepare Forms 1041 or are located in states in which accountings are not required.

Does the software have a module for preparation of the relevant state death tax returns? This can be especially important when the estate has assets in a state that has a death tax other than the pick-up of the federal state death tax credit. In states with the pick-up tax, at least through 2004, a state module permits last minute changes before the filing deadline.

Does the software run on the operating system used by the firm? With the introduction of operating systems such as Windows XP, Windows ME, Windows NT and Windows 98, some older applications may not run properly or may require more technical support than you can afford to dedicate.

The savings in time between preparing an estate tax return with Form 706 software compared to preparing a return manually (by typewriter or by hand), is such that the cost of the Form 706 software is a relatively minor concern.

Several years ago when personal computers were first appearing in law firms, an attorney (I believe it was Robert P. Wilkins) made a suggestion: to test a Form 706 program being considered for purchase or to learn a program that was purchased, enter the data from an already completed return for a small estate, In doing so, you will become familiar with the procedures to enter data as well as what is required to make the final calculations print the completed return.

Some programs perform interrelated marital and charitable deduction calculations, as well as giving warnings when the estate does not qualify for an election based upon the data entered. For example, if the estate does not qualify for alternate valuation (because it is a non-taxable estate or the alternate valuation date values are greater than the date of death values), then the program will give some sort of warning that the estate does not meet the requirements for alternate valuation. Some programs may be little more than fill in the blank forms with calculations limited to simple addition and subtraction. Such programs will give no warning when incorrect or inconsistent information is entered and may permit printing an improperly prepared Form 706.

The following software providers and programs are ones of which the author is aware and no warranty is made that the list is complete or that the information and prices are correct. They are in alphabetical order.

BNA 706 Preparer **BNA Software** **L800.372.1033** **www.bnasoftware.com**

Minimum system configuration is a 486/66 MHz with 12 MB free disk space, 32 MB Ram and a CD-Rom drive running Windows 95/98/ME, and Windows NT 4.01/2000. Cost for Form 706 Preparer is $625 for one license, $165 for each additional license up to 9, and $107.50 for each additional license from 10 to 50 users. Cost for Form 706 Preparer with 709 Preparer is $945 for one license, $115 for each additional license up to 9, and $112.50 for each additional license from 10 to 50 users. Front end programs: *BNA* Estate & Gift Tax Planner is an estate tax forecaster. It is unclear from published information if the information goes seamlessly into the Form 706 program, called Form 706 Preparer. *BNA* 709 Preparer prepares federal gift tax returns. It is unclear from published information if the information goes seamlessly into the Form 706 program. Information states that individual information is entered once for each client. As for state modules, published information states that the program calculates state taxes for all fifty states. Apparently the program prints the calculations but does not print

the completed forms for the relevant states, except California and Florida. BNA also provides IRS forms to its existing customer's at an additional rate of $625 1 user, $750 up to 3, $8.35 up to 5, and $995 up to 10. The program can be accessed by either CD-ROM or the internet and allows you to select a form, complete the information and store the completed form on your computer to be accessed later, This program, not the Form 706 preparer, performs only simple addition and subtraction.

Faster Faster Systems, LLC 508.347.0195 www.fastersystems.com

FASTER prepares the Form 706 as well of other fiduciary returns and reports, it works on W1N98/00/NT/ME/XPFL, it prepares court accountings for CT, DE, GA, MD, MA, NH, NJ, NY, NC, OH, PA, RI, SC, and VA and state tax modules for MA, NJ, and PA.

FroSystem Fx Tax CCH Incorporated 1.800.739.9998 www.tax.echgroup.com

CCH ProSystem fx Tax has fully functional programs for preparing Estate and Gift Tax Returns (Forms 706 and 709) and Fiduciary Income Tax Returns (Form 1041). CCH ProSystem fx Estate and Gift Tax program produces Forms 706 and 709 along with required supporting schedules. Automatic interrelated calculations of marital and charitable deductions are included. Information from the estate planning program CCH View Plan can be imported into the Estate and Gift Tax program using CCH Client DataXchange, State returns are produced for CA, CT, IL and NY. The federal program, which includes both Form 706 and 709, can be annual licensing fee for $850 or' processed on a per return basis for $30 per return. Applicable state programs cost $600 each, or can be processed on a per return basis for $25 per return The federal fiduciary program can be licensed for unlimited use for $1,600, or returns can be processed on a per return basis for $28 per return., The cost for state programs range from $600 to $275 each, or can be processed on a per return basis for $25 per return. System requirements include 100% IBM-compatible Pentium PC running on Windows 95 or 98, Windows NT workstation 4.0, Windows 2000 Professional or Windows Millennium, with a minimum of 64 Mb of RAM, Networks supported include: Linux RedHat 6.2 or 7.0, NetWare Version 4.2 or higher, Windows NT Server, Version 4.0 Windows 2000 Server, Windows Millennium, Windows NT Workstation*, Version 4.0, Windows 95 or 98* and Windows 2000 Professional*. [*Peer-to-peer dedicated server required.)

Heritance System DataTech Software 1.800.556.7526 www.lieritancesystem.com

Heritance System, previously marketed under the name "Quick and Easy," claims to be a "fully integrated accounting and forms software for trust and estate administration". All data is stored in a database grouped by system and client with seamless integration of federal, state and local probate and tax forms; including the Form 706 and 1041. Works with Windows 98/NT/2000/ME/XP. Federal Estate Tax package has a regular price of $799 but there may be specials. Front end programs: Form 709 US Gift Tax Returns is part of the Form T67 package. Back end programs: Form 1041 is a separate program. There are specific Estate/Inheritance packages for CA, FL, IL, IN, MO, NJ, NY, and PA.

Lacerte Form 706 Lacerte Software Corp. 1.800.765.7777 www.lacertesoftware. com

Lacerte Company has been acquired by Intuit. Form 706 has state modules for' AZ, CA, FL, NY and TX. There is a Form 709 but the available information does not make it clear if there is seamless integration with the Form 706 or the Form 706 with the Form 1041 program, which appears to have modules for all states with income taxes. For pricing contact the company. The software can be used on a per diem basis, reportedly.

Lackner 706 for Windows The Lackner Group, Inc. 1.800.709.1041 www.laclmergroup.com

This used to be called Quik 706. It underwent a recent upgrade and runs in Windows and Macintosh. The state death tax program will produce returns for CT, DE, FL, IL, IN, KY, MA, MI, MO, NC, NJ, NY, OH, PA and WA. The 6-in-1 Estate Administration System will produce a Form 706, state death tax return, Form 1041, state fiduciary income tax return, court accounting and inventory with one entry of each receipt and disbursement.

706 Plus Selden Integrated Systems

This company and it's products were purchased by Thomson-West in July 2004 and this product is no longer sold.

Tax Management- Portfolio Plus BNA

The 706 Forms that come as a CD disc perform basic addition and little more. For preparers knowledgeable about what they are doing and do not need built in controls available in other programs, their forms may be

adequate.

FPS 706 Thompson Fast-Tax 1.800.331.2533 www.fasttax.thompson.com

Thomson Fast-Tax acquired the Zane product line in September 2000. In Fall 2003, Thomson West migrated their Federal Estate Tax Returns software users to Thompson Fast-Tax. FPS Fiduciary Practice System FPS 706 prepares the Form 706. State modules are available for DE, CT, FL MA, OH, NJ, NY, PA and VA. Programs work independently or seamlessly merges together as a fully integrated software unit. Uses Microsoft Windows platform and communication technology, and that you can obtain current and historical pricing for securities through online sources which work from within the program. Front end programs: FPS 709 prepares the Form 709, Back end programs: FPS 1041 prepares Form 1041.

U.S.Trust 706/709 Brentmark Software 1.800.879.6665 www.brentmark.co

In Summer 2002, Brentmark acquired the U.S. Trust 706/709 System, which was a DOS application that runs under Windows .3.1 or later. An early September 2004 view of their Website indicated this product is no longer available.

Valuation Software

Valuation software refers to software that gives the value of publicly traded securities and government debt instruments.

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 typically give the closing value of publicly traded securities on the date of death or the last trading day before the date of death if that date is not 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 first 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 submit by e-mail, fax or the Internet the number of tares and the CUSP number for each security along with the valuation date to the valuation service provider. The valuation service provider returns the valuation information. Some software programs permit direct input of the data into the Form 706 program while other programs require 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 CUSP 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 CUSP numbers, or you may be able to impose on a friendly trust department. The main article suggests several ways to obtain CUSP numbers. 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.

Bureau Of Public Debt www.publiedebt.treas.gov

This site provides Treasury bill, note and bond auction history from 1/1/1980 to the present. It also contains a savings bond calculator. No charge.

CHART.YAHOO.COM/D

This site will give historical daily prices, including high and low, for publicly traded securities using the ticker symbol for the security. No charge

Appraise Evaluation Services, Inc. 1.888.ESI.470b www.appraiseni.com

Fees $1.35 immediate and $120 overnight per security; optional charge for security with reorganization data $1.40. Detailed capital changes additional $1.40 per security. CUSIP Number (per number) $2. Cost basis for equities adjusting for stock splits $0.65 urn., $0.55 ov. EZPrice: Historical high, low, close and mean pricing $0.65 im., $0.55 ov, Lookup: Research tools for individual securities, capital changes $0.75 per access; Dividend Data History $1.00 per issue; CUSIP Numbers $1.00 per CUSIP; Stock split history $1.00 per issue; Lookup Connect Charge $0.40 per minute. Appraise.Windows Software is $125; Appraise.ASP Yearly maintenance fee $75.00, and one time set up fee $50.00.

EVP Estate Valuations & Pricing Sys tems, Inc. 1.800.237.3440 www.evpsys.com

This company had a contract with the IRS through 2003 to provide on-line automated valuation services of stocks and bonds for estate and gift tax returns. EVP Office XP, the latest version of Estate Val, Cost Basis and Cap Watch, can be downloaded immediately for free or, if you prefer, is available in CD form by mail, The service covers equities, municipal bonds, mutual Rinds, savings bonds, corporate and government bonds, GNMAs, FNMAs, FHLMCs, CMOs, UITs, and U.S. Treasuries. Valuations are $1.55 per security and $4.00 per CMO. There are no set up charges or charges for additional users. You can download the updates free of charge to your computer. If you plan to submit your information by mail, 5855 Topanga Canyon Blvd., Suite 520, Woodland Hills, CA 91367, the charges are $4.00 per security or research request. If the report asks for 20 or less CUSIPS to be "looked up", there is no extra charge. Any requests for CUSP numbers over 20 will be billed at $10.00 per report. If you need your valuation returned to you by fax 818.313.6313 there is a $10.00 charge.

FDS Financial Data Service, Inc. 1.800.399.3008 www.financialdata.com

Stocks, bonds, mutual funds $2.95; Mortgage backed securities, CMO'S $5.00; Transfer Agents, obsolete securities, and special research $8.50; Same day service (per security) $ 6.50; Estate Handling Charge $15.00; Fax Return Service (per page) $1.50; CUSIP Lookup (20 or more per estate) $10.00, Wallace EZ Link 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 $1,095 with monthly updates, $750 for quarterly updates, $375 for semiannual updates, and $250 for annual update, plus $1.55 for online search per security.

SPARDATA Securities Pricing and Research, Inc. 1,800.895.4100 www.spardita.com

This company's website is primarily an advertisement for their closely held business valuation services. Under "'Resources" and "Partnership Trades", there is a free database listing and codes since 1994 for over 3,500 public limited partnerships. No charge.

TAX FORMS ON CD ROMS

These programs give fill-in-the-blank forms, but produce no calculations beyond simple addition, if that.

Forms Library Kleinrock Publishing, Inc. 1.800.678.2315 www.kleinrock.com

Superform Stf Services 1.800.541,7197 www.stfservices.com

U.S. Government Printing Office www.irs.gov www.ins.ustreas.gov

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APPENDIX E
U.S. Estate (and Generation-Skipping Transfer) Tax Return
for
John Q. Sample

TABLE OF CONTENTS

[Entries do not necessarily correspond with the sample return.]

Tab	Document
1	Copy of Correspondence to IRS and Receipt of Acknowledgment
2	Statement from Richard V. Sample, Independent Executor, re: Discharge of Personal Liability
3	Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and accompanying Schedules
4	Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes with copy of the cashier's check payable to the Internal Revenue Service, dated July 30, 2004, in the amount of $2,100,000. Explanation of additional payments of tax.
5	Death Certificate
6	Certified Copy of Last Will and Testament of John Q. Sample
7	Copy of Correspondence to Comptroller of Public Accounts
8	Estate Tax Closing Document
9	Inheritance Tax Return
10	Correspondence from Comptroller of Public Accounts, granting an extension of time to file to January 30, 2005, with copy of check payable to the State Treasurer, dated July 30, 2004, in the amount of $667,139. Proof' of payment of state taxes.
11	Form 709, United States Quarterly Gift Tax Return for 1972
12	Form 709, United States Quarterly Gift Tax Return for 1976
13	Form 709, United States Gift Tax Return for 1982
14	Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return for 1989
15	Schedule A, Item 1, Proper Title Company Closing Statement
16	Schedule A, Item 2, Appraisal of Socios Ranch in Frio County
17	Schedule A, Item 3, Appraisal of Travis Street Commercial Building
18	Schedule A, Item 4, Bexar Appraisal District Ad Valorem Tax Valuation of residence at 987 Maple Street, San Antonio, TX
19	Schedule B, Items 1 to 22, Evaluation of Publicly Traded Securities
20	Schedule B, Item 23, Appraisal of Wrangler Automotive Parts Common Stock Wrangler Automotive Parts Balance Sheets and Income Tax Returns for Five Years
21	Schedule C, Item 8, Unsecured Promissory Note, C. Guy Dancy and Dancy Energy Company, Makers
22	Schedule C, Item 8, Valuation of C. Guy Dancy Note
23	Schedule D, Item 1, Form 712 from Real Fine Mutual Life Insurance Company (Term Life Policy No. 1,439,242)
24	Schedule D, Item 2, Form 712 from Real Fine Mutual Life Insurance Company (Term Life Policy No. 787,679)
25	Schedule D, Item.3, Form 712 from Escatalogical Insurance Company of America (Preferred Protector Policy No. 51,525,354)
26	Schedule E, Part 2, Item 1, Evaluation of Publicly Traded Securities Explanation of Co-Tenant's Ownership
27	Schedule F, List and Explanation of Safety Deposit Box Items Excluded from Gross Estate
28	Schedule F, Item 2, Appraisal from Eyes A Poppin Jewelers
29	Schedule F, Item 4, Appraisal from Gallagher Used Furniture
30	Schedule F, Item 5, Appraisal from Nocheatme Twice Coins
31	Schedule F, Item 22, Appraisal 24.75% Limited Partnership Interest in W.C. Ranch Ltd, Limited Partnership Agreement Balance Sheets and Income Tax Returns for Five Years

32 Schedule F, Item 23, Form 712, Policy on Life of Decedent's spouse
33 Schedule G, Item 1, The Harold H. Sample Trust
34 Schedule G, Item 1, Trust Valuation
35 Schedule G, Item 2, Last Will and Testament of Lilian Sample
36 Schedule G, Item 3, The John Q. Sample Management Trust
37 Schedule G, Item 3, Estate Valuation, United States Treasury Bills
38 Schedule G, Item 4, The Richie Sample Trust of 1998
39 Schedule H, Item 1, Will of George Perkins
40 Schedule K, Item 1, Note Payable by John Q, Sample
41 Schedule M, Election of Marital Deduction for Marital Trust A
42 Schedule M, Certified Copy of Order Admitting Will to Probate
43 Schedule M, Qualified Disclaimer of Property Passing to Decedent's Spouse
44 Schedule 0, Certified Copy of Order Admitting Will to Probate (not needed if attached for Schedule M)
45 Schedule R, Part I.B., Line 9

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APPENDIX F
VALUATION REPORT CHECKLIST[1]

Company:_____Valuation Date: _____

Completed by:_____ Date: _____

This checklist can be used to assist internal accountants and analysts in preparing full written valuation reports that comply with professional requirements in those relatively rare cases when such reports are needed. The "Authoritative Reference" column cites the professional literature that requires each procedure. References preceded by "ASA" refer to The Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers. References preceded by "SR" refer to standards rules of the Uniform Standards of Professional Appraisal Practice of the Appraisal Foundation. "BVS" refers to BVS-VII, "Comprehensive Written Business Valuation Report," issued by the, ASA Business Valuation Committee. "IBA" refers to Standard 5, "Formal Written Appraisal Reports" issued by the Institute of Business Appraisers. Analysts should consider the professional requirements that apply to their professions such as AICPA. An asterisk (*) appearing in the "Authoritative Reference" column identifies an additional item recommended by the authors.

[1]This Exhibit in the IRS Business Valuation Guidelines states that it is reproduced with permission by Jay E. Fishman.

INSTRUCTIONS: Answer each question with a checkmark (✓) in the appropriate column:
(a) Yes - item included in the report,
(b) No - item is applicable but is omitted from the report (any item checked "No" should be explained on the checklist or in a separate memorandum); or
(c) N/A - the item is either not applicable or insignificant to the current engagement. A block has been provided for each major disclosure caption. If the major caption is not applicable for this engagement, you may place a ✓in the . Then it will not be necessary to check N/A for each question under the caption.

Authoritative Reference	**PROCEDURE**	Yes	No	N/A
	GENERAL			
	1. Is the material in the report relevant and free of unnecessary boilerplate?			
	2. Are all calculations mathematically correct?			
	3. Do the data and analyses in the report lead logically to a well supported conclusion?			
	4. Does the report contain all relevant factors and data?			
	5. Do the data and valuation methods used conform properly to the Definition of value stated in the report?			
	6. Is all technical jargon clearly defined?			
BVS and IBA	7. Does the report consider all the requirements relating to the circumstances of the engagement (IRS requirements, DOL Regulations, legal precedents, etc.)?			

Authoritative Reference	PROCEDURE	Yes	No	N/A
	INTRODUCTION			
BVS and IBA	8. Is the following information disclosed: a. The client's name.			
ASA 8.1, BVS, IBA and SR 10-2	b. Subject company and ownership interest.			
ASA 8.1, BVS, IBA and SR 10-2	c. Any special rights or restrictions relating to the subject interest.			
ASA 8.1, BVS, IBA and SR 10-2	d. The valuation date.			
ASA 8.1, BVS, IBA and SR 10-2	e. The purpose of the valuation.			
ASA 8.1, BVS, IBA and SR 10-2	f. Definition of value used (fair market value, fair value, etc.)			
ASB 8.1, BVS, IBA and SR 10-2	g. Report date.			
ASA 8.1, BVS, IBA and SR 10-2	h. Sources of data used in the valuation.			
	COMPANY BACKGROUND			
ASA 8.1, BVS, IBA, SR 9-4, and SR 10-2	9. Does the report provide general information about the company and its history? Such information may include: • Type of industry. • Products/services markets, and customers. • Legal form. • State of incorporation. • Company history. • Company management. • Ownership (types of stock). • Competition. • Sensitivity to seasonal or cyclical factors. • Strengths and weaknesses.			
ASA 8.1, BVS, IBA, SR 9-4, and SR 10-2	10. Does the report discuss relevant financial information about the company? Such information may include: • Financial condition, including major assets. • Profitability and earnings capacity. • Dividend-paying capacity. • Value of goodwill or other intangibles. • Transactions in the company's stock. • Outlook for the company.			
	FINANCIAL STATEMENT DATA ☐			
ASA 8.1, ASA 8.3, BVS, and SR 10-2	11. Does the report include financial statement data that is relevant to the valuation?			
BVS	12. If the financial statement data was adjusted, are all the adjustments explained?			

Authoritative Reference	PROCEDURE	Yes	No	N/A
BVS	13. If prospective financial information was used in the valuation: a. Is that information presented in the report? b. Are key underlying assumptions discussed?			
See Sec. 910	14. [CPAs only] If historical financial statements are presented, have AICPA requirements been met?			
See Sec. 910	15. [CPAs only] If prospective financial information is presented, have AICPA requirements been met? Practical Considerations: • A separate report on prospective financial information is only required for complete presentations intended for third-party use. • For partial presentations or internal use reports, the valuation report should include statements that prospective results may not be achieved and that the report is restricted to internal use (or specific named parties, if applicable). • Partial presentations should only be used for internal use or for parties with whom the company is directly			
ECONOMIC AND INDUSTRY DATA ☐				
ASA 8.1, ASA 8.3, BVS, IBA, SR 9-4, and SR 10-2	16. Does the report discuss relevant economic and industry factors that affect the valuation? Such information may include: • National economic data. • Regional and local economic data. • Industry trends or financial data (including comparison to company data).			
SEARCH FOR COMPARATIVES				
IBA, SR 9-4, and SR 10-2	17. Does the report discuss what steps were taken to search for comparative companies, the sources used, and the results of that search?			
ASA 8.1, ASA 8.3 and SR 10-2	18. If any comparatives were found, does the report provide relevant financial data for each comparative and discuss any adjustments made to that data?			
	19. Is the report consistent with regard to: a. Making similar adjustments for the subject company and comparatives?			
	b. Making appropriate adjustments to comparative data that relate to a time period that differs from subject company data?			
VALUATION METHODS ☐				
ASA 8.4, BVS, IBA SR 9-5, and SR 10-2	20. Does the report discuss all the relevant valuation methods that were considered in the engagement, which ones were selected, and the basis for that selection?			

Authoritative Reference	PROCEDURE	Yes	No	N/A
BVS, IBA, and ASA 8.4	21. Does the report provide a brief description of each method selected an how it was used?			
ASA 6.2, IBA, SR 10- 1, and SIR 10-2	22. Are valuation calculations presented in enough detail that the reader can re-perform those calculations from the data given from the data given?			
BVS, IBA, and SR 10-2	23. Does the report explain how all key variables (discount rates, value multiples, etc.) were determined and used?			
	24. Are risk factors relating to the subject company and ownership interest adequately analyzed, including their effects on variables?			
	25. Is the report consistent with regard to: a. Applying valuation multiples to the proper parameter (earnings, net cash flow, etc.)?			
	b. Applying discount or capitalization rates to the proper parameter?			
	26. Does the report avoid mixing pretax and after-tax data where appropriate?			
	VALUATION CONCLUSION			
SR-9-5 and SR 10-2	27. Does the report discuss how the values indicated by the methods used were weighted to determine a final value estimate?			
BVS, IBA, and SR 10-2	28. If any adjustments for control, non-marketability, etc. were applied, does the report explain them and how they were determined?			
	ADDENDA MATERIAL			
ASA 8.5, BVS	29. Does the report include a statement on the independence (or state why the accountant/analysis is not independent)?			
IBA, and SR 10-3	30. Does the report include a list containing the accountant/analyst qualifications?			
ASA 6-4, BVS, IBA, SR 10-1, and SR 10-3	31. Does the report contain a list containing the following assumptions and limiting conditions, where applicable: a. Reliance on information from management or others without verification.			
	b. Restrictions on use of the report.			
	c. Caveat that report is only valid for the date specified.			
	d. Other matters unique to the engagement.			

Authoritative Reference	PROCEDURE	Yes	No	N/A
BVS, IBA, and SR 10-3	32. If applicable, does the report include the certifications required by Uniform Standards of Professional Appraisal Practice? Practical Consideration: • These certifications are only required if the accountant/analyst purports to have conduced the valuation and prepared the report in conformity with the Uniform Standards of Professional Appraisal Practice.			
	SIGNATURES			
ASA 8.8, BVS, IBA and SR 10-2	33. Has the report been signed by the person who (a) performed or supervised the valuation and (b) assumes technical responsibility for it?			
	Practical Consideration: • If a CPA signs the firm's name on the report, then the report should disclose the name of the person responsible for the engagement.			
ASA 8.8	34. If there are any collaborating appraisers who agree with the report's findings, have they also signed the report?			
ASA 8.8	35. If there are any collaborating appraisers who disagree with the report's findings, does the report include their dissenting opinions?			
	SPECIAL REPORTS			
ASA 8.3	36. If this is a hypothetical valuation, does the report: a. Clearly indicate that the valuation is hypothetical?			
	b. Explain why a hypothetical valuation was performed.			
	c. State the assumed hypothetical conditions used.			
ASA 8.3	37. If this is a fractional valuation, does the report: a. Clearly indicate that the valuation is fractional?			
	b. Provide restrictions on the report's use?			
ASA 8.3	38. If this is a preliminary report, does the report: a. Clearly indicate that the report is preliminary?			
	b. Provide restrictions on the report's use?			

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APPENDIX G

Sample Return

Form **706**
(Rev August 2003)
Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see separate instructions).
To be filed by decedents dying after December 31, 2002 and before January 1, 2004
For Paperwork Reduction Act Notice, see the separate instructions.

OMB No 1545-0015

Part 1 Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any): John Q.	1b Decedent's last name: Sample		2 Decedent's Social Security No.: 257-72-1464
3a Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country): Bexar County, Texas	3b Year domicile established: 1969	4 Date of birth: 11/12/1917	5 Date of death: 09/30/2003
6a Name of executor (see page 3 of the instructions): Richard V. Sample	6b Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code): 1313 Ruele San Antonio, Texas 78299		
6c Executor's social security number (see page 3 of the instructions): 987-65-4321			
7a Name and location of court where will was probated or estate administered: Probate Court No. One, Bexar County, Texas 78205			7b Case number: 02-PC-333333

8 If decedent died testate, check here ▶ ☒ and attach a certified copy of the will. 9 If Form 4768 is attached, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐

Part 2 Tax Computation

1	Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12)		1	19,776,986
2	Total allowable deductions (from Part 5, Recapitulation, page 3, item 23)		2	16,286,737
3	Taxable estate (subtract line 2 from line 1)		3	3,490,249
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))		4	0
5	Add lines 3 and 4		5	3,490,249
6	Tentative tax on the amount on line 5 from Table A on page 4 of the instructions		6	1,511,022
7	Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)		7	0
8	Gross estate tax (subtract line 7 from line 6)		8	1,511,022
9	Maximum unified credit (applicable credit amount) against estate tax	9 345,800		
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 5 of the instructions.)	10 0		
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)		11	345,800
12	Subtract line 11 from line 8 (but do not enter less than zero)		12	1,165,222
13	Credit for state death taxes (cannot exceed line 12) **Attach credit evidence** (see instructions). Figure the credit by using the amount on line 3 less $60,000. See Table B in the instructions. Enter the amount here from Table B ▶ 228,264 x .50 ▶		13	114,132
14	Subtract line 13 from line 12		14	1,051,090
15	Credit for Federal gift taxes on pre-1977 gifts (sec 2012)(attach computation)	15		
16	Credit for foreign death taxes (from Schedule(s) P) (Attach Form(s) 706-CE.)	16		
17	Credit for tax on prior transfers (from Schedule Q)	17		
18	Total (add lines 15, 16, and 17)		18	0
19	Net estate tax (subtract line 18 from line 14)		19	1,051,090
20	Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)		20	353,359
21	Total transfer taxes (add lines 19 and 20)		21	1,404,449
22	Prior payments. Explain in an attached statement	22		
23	United States Treasury bonds redeemed in payment of estate tax	23		
24	Total (add lines 22 and 23)		24	0
25	Balance due (or overpayment) (subtract line 24 from line 21)		25	1,404,449

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Signature(s) of executor(s) — Date

711 Navarro, Sixth Floor
San Antonio TX 78205

Signature of preparer other than executor — Address (and ZIP code) — Date

DIA

Estate of: John Q. Sample 257-72-1464

Part 3.—Elections by the Executor

Please check the "Yes" or "No" box for each question. (See instructions beginning on page 6.)		Yes	No
1 Do you elect alternate valuation?	1	X	
2 Do you elect special use valuation? If "Yes," you must complete and attach Schedule A-1.	2		X
3 Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described on page 9 of the instructions.	3	X	
4 Do you elect to postpone the part of the taxes attributable to a reversionary or remainder interest as described in section 6163?	4		X

Part 4—General Information (Note: Please attach the necessary supplemental documents. You must attach the death certificate.) (See instructions on page 10.)

Authorization to receive confidential tax information under Regs. sec. 601.504(b)(2)(i); to act as the estate's representative before the IRS; and to make written or oral presentations on behalf of the estate if return prepared by an attorney, accountant, or enrolled agent for the executor.

Name of representative (print or type)	State	Address (number, street, and room or suite no., city, state, and ZIP code)

I declare that I am the ☐ attorney/ ☐ certified public accountant/ ☐ enrolled agent (you must check the applicable box) for the executor and prepared this return for the executor. I am not under suspension or disbarment from practice before the Internal Revenue Service and am qualified to practice in the state shown above.

Signature	CAF number	Date	Telephone number

1 Death certificate number and issuing authority (attach a copy of the death certificate to this return)
444447 San Antonio Metropolitan Health District

2 Decedent's business or occupation. If retired, check here ▶ ☒ and state decedent's former business or occupation.
Car Dealer

3 Marital status of the decedent at time of death:
- ☒ Married
- ☐ Widow or widower—Name, SSN and date of death of deceased spouse ▶
- ☐ Single
- ☐ Legally separated
- ☐ Divorced—Date divorce decree became final ▶

4a Surviving spouse's name	4b Social security number	4c Amount received (see page 10 of the instructions)
Mary Sample	555-25-2525	205,028

5 Individuals (other than the surviving spouse), trusts, or other estates who receive benefits from the estate (do not include charitable beneficiaries shown in Schedule O)(see instructions). For Privacy Act Notice (applicable to individual beneficiaries only), see the Instructions for Form 1040.

Name of individual, trust, or estate receiving $5,000 or more	Identifying number	Relationship to decedent	Amount (see instructions)
Dixie C. Sample	434-34-3434	Daughter	
Richard V. Sample	987-65-4321	Son	
Elizabeth O. Sample	898-98-9898	Granddaughter	
All unascertainable beneficiaries and those who receive less than $5,000 ▶			
Total			0

Please check the "Yes" or "No" box for each question.	Yes	No
6 Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate) (see page 11 of the instructions)?	X	

(Continued on next page)

Part 4.—General Information (continued) John Q. Sample

Please check the "Yes" or "No" box for each question.	Yes	No
7a Have Federal gift tax returns ever been filed? If "Yes," please attach copies of the returns, if available, and furnish the following information:		X
7b Period(s) covered / 7c Internal Revenue office(s) where filed		
If you answer "Yes" to any of questions 8-16, you must attach additional information as described in the instructions.		
8a Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?		
b Did the decedent own any insurance on the life of another that is not included in the gross es tate?		
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? If "Yes," you must complete and attach Schedule E	X	
10 Did the decedent, at the time of death, own any interest in a partnership or unincorporated business or any stock in an inactive or closely held corporation?		
11 Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G beginning on page 13 of the separate instructions)? If "Yes," you must complete and attach 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 Any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		
13 Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		
14 Was the marital deduction computed under the transitional rule of Public Law 97-34, section 403(e)(3) (Economic Recovery Tax Act of 1981)? If "Yes," attach a separate computation of the marit al deduction, enter the amount on item 20 of the Recapitulation, and note on item 20 "computation attached."		
15 Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I? If "Yes," you must complete and attach Schedule I.		
16 Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation		X

Part 5.—Recapitulation

Item number	Gross estate		Alternate value	Value at date of death
1	Schedule A-Real Estate	1	2,294,492	2,280,410
2	Schedule B-Stocks and Bonds	2	1,262,544	1,295,625
3	Schedule C-Mortgages, Notes, and Cash	3	6,800,080	6,800,080
4	Schedule D-Insurance on the Decedent's Life (attach Form(s) 712)	4	35,230	35,230
5	Schedule E-Jointly Owned Property (attach Form(s) 712 for life insurance)	5	14,866	15,091
6	Schedule F-Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6	6,666,811	6,695,943
7	Schedule G-Transfers During Decedent's Life (attach Form(s) 712 for life insurance)	7	1,928,952	1,996,181
8	Schedule H-Powers of Appointment	8	313,475	313,475
9	Schedule I-Annuities	9	460,536	460,536
10	Total gross estate (add items 1 through 9)	10	19,776,986	19,892,571
11	Schedule U-Qualified Conservation Easement Exclusion	11	0	0
12	Total gross estate less exclusion(subtract item 11 from item 10). Enter here and on line 1 of Part 2—Tax Computation	12	19,776,986	19,892,571

Item number	Deductions		Amount
13	Schedule J-Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims	13	75,301
14	Schedule K-Debts of the Decedent	14	5,096,040
15	Schedule K-Mortgages and Liens	15	205,255
16	Total of items 13 through 15	16	5,376,596
17	Allowable amount of deductions from item 16 (see the instructions for item 17 of the Recapitulation)	17	5,376,596
18	Schedule L-Net Losses During Administration	18	7,750
19	Schedule L-Expenses Incurred in Administering Property Not Subject to Claims	19	8,793
20	Schedule M-Bequests, etc. to Surviving Spouse	20	205,028
21	Schedule O-Charitable, Public, and Similar Gifts and Bequests	21	10,688,570
22	Schedule T-Qualified Family-Owned Business Interest Deduction	22	0
23	Total allowable deductions (add items 17 through 22). Enter here and on line 2 of the Tax Computation	23	16,286,737

Estate of: John Q. Sample 257-72-1464

SCHEDULE A–Real Estate

- For jointly owned property that must be disclosed on Schedule E, see the instructions on the reverse side of Schedule E.
- Real estate that is part of a sole proprietorship should be shown on Schedule F.
- Real estate that is included in the gross estate under section 2035, 2036, 2037, or 2038 should be shown on Schedule G.
- Real estate that is included in the gross estate under section 2041 should be shown on Schedule H.
- If you elect section 2032A valuation, you must complete Schedule A and Schedule A-1.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	Decedent's residence CB 5274B, Blk 10, Lot 52, Pershing Hills Unit-3, at 272 Geneseo, San Antonio, Bexar County, Texas. Value from tax appraisal, attached.	03/30/04	287,222	287,222
2	Condominium at 3000 N. New Braunfels #48, San Antonio, Texas 78209, Decedent's principal residence. Value based upon sale of residence after Decedent's death. Copy of closing statement attached.	12/30/03	164,674	164,674
	<<No legal description is included, but this is probably not a problem for a condominium.>>			
3	Residence, rental property, CB 23, Blk 5, Lot 10, Henderson's Subdivision, at 616 SW 10th, Premont, Jim Wells County, Texas. Decedent owned an undivided one-half community interest. Value from ad valorem tax statement, attached, reduced by 25% for undivided interest.	03/30/04	151,555	151,555
	Accrued unpaid rent.		95	95
	<<It may be adequate for a non-taxable estate to take a discount without an opinion from an appraiser.>>			
	Total from continuation schedules or additional sheets attached to this schedule		1,690,946	1,676,864
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 1.)		2,294,492	2,280,410

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)

(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule A
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<An income producing property only includes income receivable on date of death and does not include income earned between date of death and alternate valuation date.>>				
4	Decedent's residence CB 4725B, Blk 10, Lot 25, Legend Hills Unit-3, at 2900 Washita Way, San Antonio, Texas. Value from appraisal attached.		03/30/03	261,200	261,200
	Community property share of Decedent's spouse.		03/30/03	130,600	130,600
	<<This method can be used where no discount is taken for an undivided interest. See Item 3 for how to take a discount.>>				
5	439.08 acres of ranchland located in Gonzalez County, Texas. Legal description attached. Decedent owned an undivided one-third interest. Value per appraisal attached.		03/30/03	400,000	400,000
	<<In a taxable estate the discount should be given by the appraiser and the value reported on the return should be the value after the discount.>>				
6	Various Texas oil and gas properties, list and valuation attached.		03/30/03	79,334	90,659
	Unpaid production.		03/30/03	30,668	8,476
	TOTAL. (Carry forward to main schedule.)				

See the instructions on the reverse side

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule A
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<When alternate valuation is elected, all production from date of death to the alternate valuation date must be listed.				
7	Various Oklahoma oil and gas properties; list and valuation attached.		03/30/03	34,577	42,360
	Unpaid production.		03/30/03	13,221	2,223
	<<Listing minerals separately for each state facilitates preparing the state returns.				
8	Various non-producing oil and gas interests.			1	1
9	Mission Burial Park plots, San Antonio, Texas, 2 burial plots, Lots 66 & 67.		03/30/03	1	1
	<<Because burial plots are not included in the gross estate, the author would probably not list these.>>				
10	Ranger Apartments, rental property Decedent contracted to purchase at 401 Broad Ave., San Antonio, Bexar County, Texas. Copy of earnest money contract attached. Value based on contract price.		03/30/03	720,000	720,000
11	4 acre tract of land, Helotes, Bexar County, Texas. Legal description attached. Value based upon tax appraisal attached; less non-recourse debt explained in memo, attached.		03/30/03	21,344	21,344
	TOTAL. (Carry forward to main schedule.)			1,690,946	1,676,864

See the instructions on the reverse side

Estate of: John Q. Sample 257-72-1464

SCHEDULE B—Stocks and Bonds

(For jointly owned property that must be disclosed on Schedule E, see the instructions f or Schedule E)

Item number	Description including face amount of bonds or number of shares and par value where needed for identification Give 9-digit CUSIP number.	Unit value	Alternate valuation date	Alternate value	Value at date of death
1	ITEMS 2 AND 3 WERE VALUED THROUGH EVP, INC. AND A COPY OF THE REPORT IS ATTACHED; ITEM 4 WAS VALUAED THROUGH ESTATES, EVALUATIONS AND ESTIMATES, AND THEIR REPORT IS ALSO ATTACHED.				
2	5,000 shares AT&T CORP CUSIP: 001957109	39.4531	03/30/03	185,000	197,266
3	1,688 shares AMOCO CORP CUSIP: 031905102	92.5000	03/30/03	151,920	156,140
	Dividends 0.7 E 09/11 R 09/13 P 09/10/02		03/30/03	1,182	1,182
	<<Dividends are income in respect of a decedent and are also reported on the estate's income tax return.>>				
4	13,441.78 shares THE WALL STREET PACIFIC BASIC EQUITY FUND CUSIP: 316821206	30.2900	03/30/03	407,152	407,152
5	565 shares FLACKEY FARMS, INC., closely held. Value based on appraisal; copy attached	21.1470	03/30/03	11,948	11,948
6	250,000 par value ALICE TEX INDEPENDENT SCHOOL DISTRICT RFDG REGD 5.55%, 2/15/2004 CUSIP: 016248G42		03/30/03	258,812	258,812
	Accrued Interest: 8/15/2002 to 9/30/2002		03/30/03	1,710	1,710
	Total from continuation schedules (or additional sheets) attached to this schedule			244,820	261,415
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 2.)			1,262,544	1,295,625

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(The instructions to Schedule B are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule B
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<While tax free, this is also income in respect of a decedent.>>				
7	3,000 shares General Electric	32.5000	03/30/03	97,500	97,500
8	2,000 shares General Electric	32.5000	03/30/04	65,000	65,000
	<<This illustrates splitting the reporting when the same stock has two alternate valuation dates.>>				
9	200 shares CONSOLIDATED EDISON CO OF NEW YORK, Series A, QUICS 7.75%, 3/31/2031 CUSIP: 209111848	24.5000	03/30/03	5,000	4,900
10	4,800 shares of common stock, Tejas Title Company, a Texas closely held corporation. Value is based upon prior sale; see attached memorandum.	10.0900	03/30/03	48,432	48,432
11	Purple Martin Development Co., Inc. a Texas closely held corp. Decedent owned 99.85% of the outstanding stock. Value represents a good faith estimate of the value of the shares held by the decedent in this company valued as of the date of Decedent's death. The value is being determined by appraisal, but due to the large volume of property and business appraisals required by this estate, the written report will not be completed in time to be filed with this Return. The written report will be submitted as supplemental information after it has been received.		03/30/03	1	1
	TOTAL. (Carry forward to main schedule.)				

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule B
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<This worked for the author and it might work for you, but the IRS said not to use it as a precedent.>>				
12	925 shares of common stock in Patriot Convenience Store. The shares have no value as the company filed bankruptcy in 1997.		03/30/03	1	1
	<<If a sale brings a capital loss, the decedent needed to make the sale, because on death there was a step-down in basis.				
13	10,500 shares BroadBase Diversified Mutual Fund	2.7510	03/30/03	28,886	28,886
	Accrued interest.	0.4900	03/30/03		5,145
	Accrued capital gains.	0.8700	03/30/03		9,135
	Accrued tax-free interest.	0.2300	03/30/03		2,415
	<<Illustrates separate listings for ordinary interest, capital gains and tax-free interest.>>				
	TOTAL. (Carry forward to main schedule.)			244,820	261,415

See the instructions on the reverse side

Estate of: John Q. Sample 257-72-1464

SCHEDULE C—Mortgages, Notes, and Cash

(For jointly owned property that must be disclosed on Schedule E, see the instructions f or Schedule E.)

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	Frost National Bank, checking account no. 1234509876 in the name of the Decedent.	03/30/03	78,035	78,035
2	Cash on hand.	03/30/03	100	100
	<<Don't let clients feign ignorance that cash in the home safe is taxed.>>			
3	1,284,000 shares of The Wall Street Money Market Fund (1,000 unit value) CUSIP: 316823202	03/30/03	1,284,000	1,284,000
4	250,000 par value U.S. TREASURY NOTES, 7.125%, 10/15/2002, unit value 1.0156250 CUSIP: 912827C67	03/30/03	253,906	253,906
	Accrued Interest.	03/30/03	5,986	5,986
	<<The appraisal for this item should be attached.>>			
5	U.S. Treasury Bills held by Frost National Bank in account #4444444.	03/30/03	4,904,553	4,904,553
6	Undeposited checks on hand.	03/30/03	3,522	3,522
7	Chase Bank of Texas, 200 South Tenth - Neuhaus Tower, McAllen, Texas 78501. Certificate of Deposit Account No. 1122334455.	03/30/03	111,422	111,422
	Accrued interest on above item.	03/30/03	149	149
	Total from continuation schedules (or additional sheets) attached to this schedule		158,407	158,407
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 3.)		6,800,080	6,800,080

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule C
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
8	Michael O'Connell, Payor. Unsecured note in face amount of $682,060. Payor is not solvent. Copy of note and memorandum attached.		03/30/03	52,300	52,300
	<<Any payments on note in excess of the value reported here will be income.>>				
9	$150,000 face unsecured promissory note, Nancy Miller, Payor; annual payments of $30,000 each due February 8, 2001, through 2005, without interest. Only one payment received. Remaining note deemed worthless due to the fact that payor went into bankruptcy.		03/30/03		
10	Promissory Note for sale of house on 7th Street in Del Rio, Texas. See copy of Real Estate Lien Note and Amortization Schedule attached.		03/30/03	65,928	65,928
	Accrued interest.		03/30/03	260	260
11	Bond and mortgage of $50,000, unpaid balance: $24,000; dated January 1, 1991, John Doe to Richard Roe: premises: 22 Clinton Street, Newark, N.J., due: January 1, 2012; interest payable at 10% a year -- January 1 and July 1.		03/30/03	24,000	24,000
	Community property share of surviving spouse.		03/30/03	-12,000	-12,000
	TOTAL. (Carry forward to main schedule.)				

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule C
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<This example must be correct, because its given on Form, p. 14. Notice that no discount is taken in this example, when it probably could have a discount.>>				
12	Note of $28,000, unpaid balance $27,919.09; dated February 1, 2002; due February 1, 2012: XYZ Corp. to Decedent; interest payable monthly at 8% per annum. No accrued interest at time of death; payment made on the first of each month.		03/30/03	27,919	27,919
	TOTAL. (Carry forward to main schedule.)			158,407	158,407

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

SCHEDULE D–Insurance on the Decedent's Life

You must list all policies on the life of the decedent and attach a Form 712 for each policy.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	Indianapolis Life Insurance Company. Policy #12131415, Beneficiary Mary Sample, Decedent's spouse, in face amount of $19,000. Form 712 attached.	03/30/03	19,074	19,074
2	Great-West Life Assurance Co. Policy No. 21222324. Form 712 with application attached. Decedent was not the owner of the policy and held no incidents of ownership; not included in Decedent's estate. Owned by Sample Trust of 1992 reported on Schedule G.	03/30/03		
3	State Mutual Life Assurance Company of America, 440 Lincoln Street, Worcester, MA 01653. Policy No. 32343638, on the life of the Decedent, face amount of policy $27,250, payable to Richard V. Sample and Dixie C. Sample, Decedent's children. Community Property: Decedent owned an undivided one-half interest. Form 712 and related explanation attached.	03/30/03	15,156	15,156
4	Liberty National Life Insurance Company. Policy No. 5432154321, in the face amount of $1,000, on the life of Decedent, payable to Decedent's estate. Form 712 attached.	03/30/03	1,000	1,000
	Total from continuation schedules (or additional sheets) attached to this schedule			
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 4.)		35,230	35,230

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE E—Jointly Owned Property

(If you elect section 2032A valuation, you must complete Schedule E and Schedule A-1.)

Part 1.—Qualified Joint interests—Interests Held by the Decedent and His or He r Spouse as the Only Joint Tenants (Section 2040(b)(2))

Item number	Description For securities, give CUSIP number.	Unit value	Alternate valuation date	Alternate value	Value at date of death
1	Norwest Bank Texas, N.A., 40 N.E. Loop 410, San Antonio, Texas 78216 Advantage Checking Account #43434.		03/30/03	15,982	15,982
	Total from continuation schedules (or additional sheets) attached to this schedule				
1a	Totals			15,982	15,982
1b	Amounts included in gross estate (one-half of line 1a)			7,991	7,991

Part 2.—All Other Joint Interests

2a State the name and address of each surviving co-tenant. If there are more than three surviving co-tenants, list t he additional co-tenants on an attached sheet.

Name	Address (number and street, city, state, and ZIP code)
A Richard V. Sample	
B Dixie C. Sample	
C.	

Item number	Enter letter for co-tenant	Description (including alternate valuation date if any) For securities, give CUSIP number.	Unit value	Percentage includible	Includible alternate value	Includible value at date of death
1	A	120 shares of Apache Corp., common stock, New York Stock Exchange. Value determined per attached estate valuation.	100.0000		2,400	2,625
2	B	Checking Account No. 667788 at Del Rio National Bank, Del Rio, Texas.	100.0000		4,461	4,461
		Accrued interest.			14	14
		Total from continuation schedules (or additional sheets) attached to this schedule				
2b		Total other joint interests			6,875	7,100
3		Total includible joint interests (add lines 1b and 2b). Also enter on Part 5. Recapitulation, page 3, at item 5			14,866	15,091

(If more space is needed, attach the continuation sc hedule from the end of th is package or additional sheets of the same size.)

(See the instructi ons on the reverse side.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE F—Other Miscellaneous Property Not Reportable Under Any Other Schedule

(For jointly owned property that must be disclosed on Schedule E, see the instructions for Schedule E.)
(If you elect section 2032A valuation, you must complete Schedule F and Schedule A-1.)

	Yes	No
1 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.		
2 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.		
3 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.		

Item number	Description For securities, give CUSIP number.	Alternate valuation date	Alternate value	Value at date of death
1	Furnishings and personal items valued in accordance with attached appraisal by Classic Collections.	03/30/03	77,295	77,295
2	Spanish Colonial Art Collection valued in accordance with attached appraisal by Art Trak, Inc. Specific Bequest to San Antonio Museum of Art, less items #M17, M18, M46, M47, M48, which were bequests to Decedent's children. Total value of the collection per the appraisal $1,218,000. Item 3 reflects the value of $65,500 which went to the children.	03/30/03	1,152,500	1,152,500
	<<Separate listing for items passing to charitable organizations facilitates preparing Schedule O.			
3	Items of Spanish Colonial Art specific bequest to Richard V. Sample and Dixie C. Sample.	03/30/03	65,500	65,500
	Total from continuation schedules (or additional sheets) attached to this schedule		5,371,516	5,400,648
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 6.)		6,666,811	6,695,943

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule F
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
4	2002 individual income tax refund.		03/30/03	70,287	70,287
	Unpaid interest.		03/30/03	381	381
5	Refund USAA auto subscription account.		03/30/03	2,683	2,683
6	Refund automobile insurance premium.		03/30/03	537	537
7	Contents in residence, excluding fine art and oriental carpets. Copy of appraisal attached.		03/30/03	10,855	10,855
8	Fine art in residence. appraisal attached.		03/30/03	64,500	64,500
9	Oriental carpets in residence. Appraisal attached.		03/30/03	8,600	8,600
10	Lincoln Continental 2000 sedan automobile.		03/30/03	22,725	22,725
11	The Sample Testamentary Trust 1A; not included in Decedent's estate.				
	Accrued interest.		03/30/03	16	16
	Accrued, tax-free interest.		03/30/03	16	16
	<<A separate entry for tax-free income facilitates preparing the fiduciary income tax return.>>				
12	The Sample Testamentary Trust 1B; this is Section 2044 property and is included in Decedent's estate. Attached is a valuation of the property in the trust.		03/30/03	4,731,014	4,761,014
	Accrued income.		03/30/03	1	1
	TOTAL. (Carry forward to main schedule.)				

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule F
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	Accrued, tax-free interest.		03/30/03	73	73
13	Rex Leasing railroad car. Good faith estimate of its value		03/30/03	10,000	10,000
14	28 shares Hughpool Minerals LP. Value based on appraisal, copy attached.		03/30/03	2,080	2,080
15	Royalty interests on minerals located in various Texas counties. Value based on two years combined royalty income; calculation attached.		03/30/03	15,220	18,460
	Unpaid production on Texas minerals.		03/30/03	6,527	2,419
	<<Mineral interests that are not real property should be listed on this schedule.>>				
16	EPC 1980-1 Ltd., a 2% interest in an oil and gas partnership. Value is based on 2002 capital account.		03/30/03	24,033	24,033
17	Return of Insurance Premium from Bankers Life/Medicare.		03/30/03	196	196
18	Unpaid salary (for period 9/15/03 - 9/30/03, net of Stock Savings plan deduction.		03/30/03	1,864	1,864
19	Unpaid vacation (28 days), net of Medicare deduction.		03/30/03	12,687	12,687
	TOTAL. (Carry forward to main schedule.)				

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule F
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
20	Receivable from Maximum Properties in amount of $665,076. Value is amount determined from net equity of building available to pay debt. Debt is not represented by a note. Discounted 40% for lack of marketability and difficulty of collection.		03/30/03	72,751	72,751
21	Personal property, clothing, furniture and furnishings of Decedent.		03/30/03	5,000	5,000
	Community property share of Mary Sample (spouse of Decedent).		03/30/03	-2,500	-2,500
	<<This is a typical manner to handle contents when all of the property is going to the spouse. No appraisal is usually obtained.>>				
22	24.75% limited partnership interest in W.C. Ranch, Ltd. Appraisal report attached.		03/30/03	303,900	303,900
23	MBL Life Assurance Corporation, 520 Broad Street, Newark, NY 07102-3111, Policy No. 2670702A. Policy is on the life of the Decedent's spouse. Copy of Form 712 attached.		03/30/03	8,070	8,070
	TOTAL. (Carry forward to main schedule.)			5,371,516	5,400,648

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

SCHEDULE G—Transfers During Decedent's Life

(If you elect section 2032A valuation, you must complete Schedule G and Schedule A-1.)

Item number	Description For securities, give CUSIP number	Alternate valuation date	Alternate value	Value at date of death
A.	Gift tax paid by the decedent or the estate for all gifts made by the decedent or his or her spouse within 3 years before the decedent's death (section 2035(b))	X X X X X		
B.	Transfers includible under section 2035(a), 2036, 2037, or 2038:			
1	The Decedent established a revocable trust (a grantor trust - EIN 74-1234567) on 3/11/1992. A copy of the trust instrument is attached. All the assets held by the trust are included in this return on Schedule B. (See attached Continuation Schedule)	03/30/03		
	Total from continuation schedules (or additional sheets) attached to this schedule		1,928,952	1,996,181
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 7.)		1,928,952	1,996,181

SCHEDULE H—Powers of Appointment

(Include "5 and 5 lapsing" powers (secti on 2041(b)(2)) held by the decedent.)
(If you elect section 2032A valuation, you must complete Schedule H and Schedule A-1.)

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	In the Testamentary Trust established under the will of George Perkins, the Decedent was a beneficiary, and the property in the trust is not included in the Decedent's estate except up to the power of withdrawal, the greater of $5,000 or 5%, as given to the Decedent in the trust instrument. A copy of the Will creating the Trust is attached.	03/30/03	303,475	303,475
	Total from continuation schedules (or additional sheets) attached to this schedule		10,000	10,000
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 8.)		313,475	313,475

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(The instructions to Schedules G and H are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule G
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
	<<Some practitioners use this method where substantially all of the decedent's assets are included in the Trust.>>				
2	The Sample Family Trust of 1997, an inter vivos revocable trust included in Decedent's estate. Copy of the trust agreement attached. Items 3 through 6 included in the trust.		03/30/03		
3	20762 shares ALLTEL CORP, CUSIP 020039103. Valuation attached.		03/30/03	632,706	666,006
4	49072.035 shares IMPERIAL HOLLY CORP., CUSIP: 452835101.		03/30/03	644,645	678,574
5	Cash.		03/30/03	479,000	479,000
6	525 shares Flackey Farms, Inc. Closely held; appraisal attached at Schedule B, Item 5.		03/30/03	11,098	11,098
	<<Listing on Schedule G a revocable trust along with the trust assets more closely follows the instructions than does method 1.>>				
7	The Sample Family Trust of 1994, Decedent, Grantor, and James B. Sample, Trustee; an inter vivos irrevocable trust, not included in Decedent's estate. A copy of the trust instrument is attached.		03/30/03		

TOTAL. (Carry forward to main schedule.)

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule G
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
8	The Sample Children's Trust of 1983. Decedent was the grantor and it was a completed gift not included in the Decedent's estate. A copy of the Trust Agreement is attached.		03/30/04		
9	Gift tax paid on gifts made by decedent within three years of death.		03/30/04	124,000	124,000
10	Texas Uniform Transfers to Minors Act account for Devon Sample, John Q. Sample Custodian; Smith Barney Cash Management Account #123456789.		03/30/04	37,503	37,503
	TOTAL. (Carry forward to main schedule.)			1,928,952	1,996,181

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule H
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
2	In the Testamentary Trust established under the will of Elizabeth S. Perkins, the Decedent was a beneficiary and trustee, but distributions to decedent by himself were limited to his health, education, maintenance or support, so Decedent did not hold a general power requiring estate inclusion. A copy of the will creating the Trust is attached.		03/30/03		
3	James Perkins granted to decedent a Crummy withdrawal right in the amount of $10,000 which was unexercised on the date of Decedent's death. A copy of the Perkins Family Trust creating the withdrawal right is attached.		03/30/03	10,000	10,000
	TOTAL. (Carry forward to main schedule.)			10,000	10,000

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

SCHEDULE I—Annuities

Note: Generally, no exclusion is allowed for the estates of decedents dying after December 31, 1984 (see page 15 of the instructi ons).

	Yes	No
A Are you excluding from the decedent's gross estate the value of a lump-sum distribution described in section 2039(f)(2) (As in effect before its repeal by the Deficit Reduction Act of 1984)? If "Yes," you must attach the information required by the instructions.		

Item number	Description Show the entire value of the annuity before any exclusions	Alternate valuation date	Includible alternate value	Includible value at date of death
1	Jackson National Life No. 0076167930	03/30/03	142,915	142,915
2	Lincoln Life Annuity Contract No. 99-2113970.	03/30/03	34,449	34,449
3	Merrill Lynch IRA.	03/30/03	40,982	40,982
4	Prinicipal Mutual Life Insurance Company, 711 High Street, Des Moines, Iowa 50392, policy number 34343443, payable for the life of Decedent; on death lump sum paid to Richard V. Sample and Dixie C. Sample, Decedent's children. Contract was actually owned by the Perkins Management Trust, but included on this schedule because Decedent was the payee. Form 712 attached.	03/30/03	242,190	242,190
5	Blue Chip Company Employees' Pension Plan Monthly Survivor Benefit of $5,684.37.	03/30/03	866,780	866,780
	Amount excluded under Temporary Regulation 20.2039-IT.	03/30/03	-866,780	-866,780
	<<This pension is grandfathered and not included in the gross estate. Another way to report it would be to state that it was excluded and place the value at zero.>>			
	Total from continuation schedules (or additional sheets) attached to this schedule			
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 9.)		460,536	460,536

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)

(The instructions to Schedule I are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims

Note: Do not list on this schedule expenses of administering property not subject to claims. For those expenses, see the instructions for Schedule L.

If executors' commissions, attorney fees, etc., are claimed and allowed as a deduction for estate tax purposes, they are not allowable as a deduction in computing the taxable income of the estate for Federal income tax purposes. They are allowable as an income tax deduction on Form 1041 if a waiver is filed to waive the deduction on Form 706 (see the Form 1041 instructions).

Item number	Description	Expense amount	Total amount
	A. Funeral expenses: See Schedule attached.	8,425	
	Total funeral expenses		8,425
	B. Administration expenses:		
1	Executors' commissions—amount ~~estimated/ agreed upon/~~ paid (Strike out the words that do not apply.)		20,000
2	Attorney fees—amount estimated/ ~~agreed upon/ paid~~ (Strike out the words that do not apply.)		20,000
3	Accountant fees—amount ~~estimated/~~ agreed upon/ ~~paid~~ (Strike out the words that do not apply.)		5,000
		Expense amount	
4	Miscellaneous expenses:		
	1 Expenses from the sale of condominium. See settlement statement at Schedule A, Item 1. Sale necessary in order to raise cash and pay federal and state estate taxes.	2,093	
	<<Because it is going to be questioned, explain why it is deductible.>>		
	2 Security for residence.	2,130	
	3 Val U Ation, appraisals	15,800	
	4 Residence lawn maintenance (50%)	956	
	5 Residence Electric and gas utilities (50%).	815	
	6 Telephone service for residence for security.	82	
	Total miscellaneous expenses from continuation schedules (or additional sheets) attached to this schedule		
	Total miscellaneous expenses		21,876
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 13.)		75,301

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE K—Debts of the Decedent, and Mortgages and Liens

Item number	Debts of the Decedent-Creditor and nature of claim, and allowable death taxes	Amount unpaid to date	Amount in contest	Amount claimed as a deduction
1	Gift tax payable per 2000 Form 709, including interest			2,643,412
2	Medical expenses.			12,769
3	Property taxes on residence.			2,825
4	Miscellaneous debts paid from Decedent's account; detailed on attached schedule.			643
5	Federal income tax liability for 2002.			61,338
6	Dr. Dudley Doright, D.D.S.			7,205
7	Wages payable to caregivers.			561
	Total from continuation schedules (or additional sheets) attached to this schedule			2,367,287
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 14.)			5,096,040

Item number	Mortgages and Liens-Description	Amount
1	Mortgage on Item 1, Schedule A, Norwest Mortgage, Inc. Customer Service Department. P.O. Box 44148, Frederick, MD 21705-4148. Fixed Rate Note, face amount: $412,500. Date of death principal balance: $409,273. Interest rate: 7.875%. Dated 7/28/1995; Maturity date: 9/1/2025. Real Estate Lien Note makers were Decedent and Robert Potter, jointly and severally.	204,637
	Accrued but unpaid interest.	618
	Total from continuation schedules (or additional sheets) attached to this schedule	
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 15.)	205,255

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(The instructions to Schedule K are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

CONTINUATION SCHEDULE

Continuation of Schedule K - Debts
(Enter letter of schedule you are continuing.)

Item number	Description For securities, give CUSIP number.	Unit value (Sch B, E or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible
8	Withholding for caregivers.				161
9	Social Security for caregivers.				1,279
10	Medicare for caregivers.				299
11	AT&T.				29
12	City Public Service.				112
13	Del Mar Pharmacy				196
14	San Antonio Water System				70
15	Nasty Pest Control				28
16	Edison Electric Illuminating Co., for electric service during December, 2002.				150
	<<This is a suggested listing from the Instructions, p. 16.>>				
17	Potential liability in personal injury lawsuit against decedent.				1,800,000
	<<Not as IRS says to deduct>>				
18	Potential liability on guarantee signed by Decedent on bank note.				560,000
	<<Not as IRS says to deduct>>				
19	First Union VISA account, Decedent's one-half community property liability.				1,719
20	AdValorem Taxes on Decedent's residence, Schedule A, Item 1.				3,244
	TOTAL. (Carry forward to main schedule.)				2,367,287

See the instructions on the reverse side.

Estate of: John Q. Sample 257-72-1464

SCHEDULE L—Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims

Item number	Net losses during administration (Note: Do not deduct losses claimed on a Federal income tax return.)	Amount
1	Flood damage to Decedent's lake home, Schedule A, Item 6, on October 15, 2003. Damage was $45,200, insurance is $38,700. Decedent's one-half community liability reported.	3,250
2	Hail damage to Jaguar automobile on May 3, 2004. Auto was gift by Decedent's wife, so was Decedent's separate property and all loss was his. No insurance. $4,500 damage.	4,500
	Total from continuation schedules (or additional sheets) attached to this schedule	
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 18.)	7,750

Item number	Expenses incurred in administering property not subject to claims (Indicate whether estimated, agreed upon, or paid.)	Amount
1	Expenses of winding down John Q. Sample Marital Trust, a Section 2044 Trust of which Decedent was trustee. Schedule F, Item 17. Expenses are detailed on attached.	8,793
	Total from continuation schedules (or additional sheets) attached to this schedule	
	TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 19.)	8,793

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)

(The instructions to Schedule L are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE M—Bequests, etc., to Surviving Spouse

Election To Deduct Qualified Terminable Interest Property Under Section 2056(b)(7). —If a trust (or other property) meets the requirements of qualified terminable interest property under section 2056(b)(7), and

a. the trust or other property is listed on Schedule M, and

b. the value of the trust (or other property) is entered in whole or in part as a deduction on Schedule M,

then unless the executor specifically identifies the trust (all or a fractional portion or percentage) or other property to be excluded from the election, the executor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2056(b)(7).

If less than the entire value of the trust (or other property) that the executor has included in the gross estate is entered as a deduction on Schedule M, the executor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule M. The denominator is equal to the total value of the trust (or other property).

Election To Deduct Qualified Domestic Trust Property Under Section 2056A. —If a trust meets the requirements of a qualified domestic trust under section 2056A(a) and this return is filed no later than 1 year after the time prescribed by law (including extensions) for filing the return, and

a. The entire value of a trust or trust property is listed on Schedule M, and

b. The entire value of the trust or trust property is entered as a deduction on Schedule M,

then unless the executor specifically identifies the trust to be excluded from the election, the executor shall be deemed to have made an election to have the entire trust treated as qualified domestic trust property.

			Yes	No
1	Did any property pass to the surviving spouse as a result of a qualified disclaimer? If "Yes," attach a copy of the written disclaimer required by section 2518(b).	1		X
2a	In what country was the surviving spouse born? US			
b	What is the surviving spouse's date of birth? 02/23/1945			
c	Is the surviving spouse a U.S. citizen?	2c	X	
d	If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship?			
e	If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen?			
3	**Election out of QTIP Treatment of Annuities.**—Do you elect under section 2056(b)(7)(C)(ii) **not** to treat as qualified terminable interest property any joint and survivor annuities that are included in the gross estate and would otherwise be treated as qualified terminable interest property under section 2056(b)(7)(C)? (see instructions)	3		X

Item number	Description of property interests passing to surviving spouse	Amount
1	Trust A - Marital Trust created under Sample Revocable Living Trust. Amount passing to Trust A is established pursuant to formula on continuation sheet.	43,159
2	Schedule F, Item 1	77,295
3	Schedule F, Item 3	65,500
4	Schedule D, Item 1	19,074

	Total from continuation schedules (or additional sheets) attached to this schedule		
4	**Total** amount of property interests listed on Schedule M	4	205,028
5a	Federal estate taxes payable out of property interests listed on Schedule M	5a	
b	Other death taxes payable out of property interests listed on Schedule M	5b	
c	Federal and state GST taxes payable out of property interests listed on Schedule M	5c	
d	Add items 5a, b, and c	5d	0
6	Net amount of property interests listed on Schedule M (subtract 5d from 4). Also enter on Part 5, Recapitulation, page 3, at item 20	6	205,028

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE O—Charitable, Public, and Similar Gifts and Bequests

	Yes	No
1a If the transfer was made by will, has any action been instituted to have interpreted or to contest the will or any of its provisions affecting the charitable deductions claimed in this schedule? If "Yes," full details must be submitted with this schedule.		X
b According to the information and belief of the person or persons filing this return, is any such action planned? If "Yes," full details must be submitted with this schedule.		X
2 Did any property pass to charity as the result of a qualified disclaimer? If "Yes," attach a copy of the written disclaimer required by section 2518(b).		X

Item number	Name and address of beneficiary	Character of institution	Amount
1	John & Mary Sample Charitable Foundation 335 Northridge San Antonio, Texas 78209	priv.fndtn	7,536,070
2	San Antonio Museum of Art 200 W. Jones Avenue San Antonio, TX 78215	Charitable	1,152,500
3	San Antonio Area Foundation 110 Broadway San Antonio, TX 78205	Charitable	2,000,000

Total from continuation schedules (or additional sheets) attached to this schedule

3 Total			3	10,688,570
4a Federal estate tax payable out of property interests listed above	4a			
b Other death taxes payable out of property interests listed above	4b			
c Federal and state GST taxes payable out of property interests listed above	4c			
d Add items 4a, b, and c			4d	0
5 Net value of property interests listed above (subtract 4d from 3). Also enter on Part 5, Recapitulation, page 3, at item 21			5	10,688,570

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(The instructions to Schedule O are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

SCHEDULE P—Credit for Foreign Death Taxes

List all foreign countries to which death taxes have been paid and for which a credit is claimed on this return.

If a credit is claimed for death taxes paid to more than one foreign country, compute the credit for taxes paid to one country on this sheet and attach a separate copy of Schedule P for each of the other countries.

The credit computed on this sheet is for the _____ (Name of death tax or taxes)

_____ imposed in _____ (Name of country)

Credit is computed under the _____ (Insert title of treaty or "statute")

Citizenship (nationality) of decedent at time of death

(All amounts and values must be entered in United States money.)

1 Total of estate, inheritance, legacy, and succession taxes imposed in the country named above attributable to property situated in that country, subjected to these taxes, and included in the gross estate (as defined by statute)	
2 Value of the gross estate (adjusted, if necessary, according to the instructions for item 2)	
3 Value of property situated in that country, subjected to death taxes imposed in that country, and included in the gross estate (adjusted, if necessary, according to the instructions for item 3)	
4 Tax imposed by section 2001 reduced by the total credits claimed under sections 2010, 2011, and 2012 (see instructions)	
5 Amount of Federal estate tax attributable to property specified at item 3. (Divide item 3 by item 2 and multiply the result by item 4.)	
6 Credit for death taxes imposed in the country named above (the smaller of item 1 or item 5). Also enter on line 18 of Part 2, Tax Computation	0

SCHEDULE Q—Credit for Tax on Prior Transfers

Part 1.—Transferor Information

	Name of transferor	Social security number	IRS office where estate tax return was filed	Date of death
A	John Q. Sample	987-65-4321	Transylvaia	04/01/02
B				
C				

Check here ▶ ☐ if section 2013(f) (special valuation of farm, etc., real property) adjustments to the computation of the credit were made (see page 21 of the instructions).

Part 2.—Computation of Credit (see instructions beginning on page 20)

Item	Transferor A	Transferor B	Transferor C	Total A, B, & C
1 Transferee's tax as apportioned (from worksheet (line 7 ÷ line 8) x line 35 for each column)	11,355			
2 Transferor's tax (from each column of worksheet, line 20)	80,000			
3 Maximum amount before percentage requirement (for each column, enter amount from line 1 or 2, whichever is smaller)	11,355			
4 Percentage allowed (each column) (see instructions)	%	%	%	
5 Credit allowable (line 3 x line 4 for each column)				
6 TOTAL credit allowable (add columns A, B, and C of line 5). Enter here and on line 17 of Part 2, Tax Computation				0

 (The instructions to Schedules P and Q are in the separate instructions.)

John Q. Sample

Schedule R—Generation-Skipping Transfer Tax

257-72-1464

Note: To avoid application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under section 2612 even if the form is not required to be filed to report estate or GST tax.

The GST tax is imposed on taxable transfers of interests in property located **outside the United States** as well as property located inside the United States

See instructions beginning on page 21.

Part 1.—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) (Special QTIP) Election

You no longer need to check a box to make a section 2652(a)(3) (special QTIP) election. If you list qualifying property in Part 1, line 9, below, you will be considered to have made this election. See page 23 of the separate instructions for details.

1 Maximum allowable GST exemption	1	1,120,000
2 Total GST exemption allocated by the decedent against decedent's lifetime transfers	2	
3 Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers	3	
4 GST exemption allocated on line 6 of Schedule R, Part 2	4	
5 GST exemption allocated on line 6 of Schedule R, Part 3	5	
6 Total GST exemption allocated on line 4 of Schedule(s) R-1	6	
7 Total GST exemption allocated to intervivos transfers and direct skips (add lines 2-6)	7	
8 GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1)	8	1,120,000
9 Allocation of GST exemption to trusts (as defined for GST tax purposes):		

A Name of trust	B Trust's EIN (if any)	C GST exemption allocated on lines 2-6, above (see instructions)	D Additional GST exemption allocated (see instructions)	E Trust's inclusion ratio (optional-see instructions)
Sample Children's Trust of 1983 Allocation pursuant to formula attached.			760,000	

9D Total. May not exceed line 8, above	9D	760,000
10 GST exemption allocated to section 2032A interests received by individual beneficiaries (subtract line 9D from line 8). You must attach special use allocation schedule (see instructions)	10	0

(The instructions to Schedule R are in the separate instructions.)

Estate of: John Q. Sample 257-72-1464

Part 2.—Direct Skips Where the Property Interests Transferred Bear the GST Tax on the Direct Skips

Name of skip person	Description of property interest transferred	Estate tax value
Margaret D. Sample	Cash on property in kind.	500,000
Joseph D. Sample	Schedule A, Item 3, apartment building. Exemption on allocation at value as finally determined for estate tax purposes.	300,000
Guy C. Sample	Residuary of Decedent's estate. Receives maximum amount of GST exemption remaining after allocations to Margaret D. Sample and Joseph D. Sample.	200,000

1 Total estate tax values of all property interests listed above	1	1,000,000
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3 GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 2 (see instructions)	3	
4 Total fixed taxes and other charges (add lines 2 and 3)	4	
5 Total tentative maximum direct skips (subtract line 4 from line 1)	5	1,000,000
6 GST exemption allocated	6	
7 Subtract line 6 from line 5	7	1,000,000
8 GST tax due (divide line 7 by 3.040817)	8	328,859
9 Enter the amount from line 8 of Schedule R, Part 3	9	24,500
10 Total GST taxes payable by the estate (add lines 8 and 9) Enter here and on line 20 of Part 2—Tax Computation on page 1.	10	353,359

Estate of: John Q. Sample 257-72-1464

Part 3.—Direct Skips Where the Property Interests Transferred Do Not Bear the GST Tax on the Direct Skips

Name of skip person	Description of property interest transferred	Estate tax value
Elizabeth O Sample	Cash	50,000

1 Total estate tax values of all property interests listed above	1	50,000
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3 GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 3 (see instructions)	3	
4 Total fixed taxes and other charges (add lines 2 and 3)	4	
5 Total tentative maximum direct skips (subtract line 4 from line 1)	5	50,000
6 GST exemption allocated	6	
7 Subtract line 6 from line 5	7	50,000
8 GST tax due (multiply line 7 by .49). Enter here and on Schedule R, Part 2, line 9	8	24,500

Internal Revenue Service
Cincinnati, OH 45999

Contact Person:
Badge Number:
Telephone:
(Not Toll Free)

▸ **Date:**

Estate Tax Closing Document
(Not a bill for tax due)

Executor or POA name Richard V. Sample
▸ Address: 1313 Ruele
▸ Address:
▸ City, State, and ZIP: San Antonio, Texas 78299

Estate Name: John Q. Sample
Social Security Number: 257-72-1464
Date of Death: 09/30/2003

We have determined the following:

- ▸ NET ESTATE TAX: $
- ▸ STATE DEATH TAX CREDIT: $
- ▸ GENERATION-SKIPPING TAX: $

These figures do not include any interest or penalties that may be charged.

Please keep this document in your permanent records. You may need it to complete administration of the estate, such as: close probate proceedings, transfer title to property, and settle state taxes. Keep it with your cancelled checks(s) to show that you have met the estate tax obligation. **Proof of payment in the amount shown above releases you of personal liability (IRC 2204). If the time for payment is extended under section 6161, 6163 or 6166, personal liability is not released until full payment has been received.**

We will not reopen this return unless you notify us of changes to the return, or there is evidence of misrepresentation of a material fact, a clearly defined substantial error based upon an established Service position or a serious administrative omission. (See IRC 7121).

▸ Signature of Authorized Official	Title	Date

▸ c.c. Power of Attorney

Worksheet for Schedule Q - Credit for Tax on Prior Transfers

state of: John Q. Sample SSN: 257-72-1464

Part I Transferor's tax on prior transfers

Item	Transferor (From Schedule Q) A	B	C	Total for all transfers (line 8 only)
1. Gross value of prior transfer to this transferee	100,000			
2. Death taxes payable from prior transfer				
3. Encumbrances allocable to prior transfer				
4. Obligations allocable to prior transfer				
5. Marital deduction applicable to line 1 above, as shown on transferor's Form 706				
6. Total (lines 2, 3, 4, and 5)				
7. Net value of transfers (line 6 from line 1)	100,000			
8. Net value of transfers (columns A, B, & C of line 7)				100,000
9. Transferor's taxable estate	10,000,000			
10. Federal estate tax paid	4,000,000			
11. State death taxes paid	1,000,000			
12. Foreign death taxes paid				
13. Other death taxes paid				
14. Total taxes paid (lines 10, 11, 12, and 13)	5,000,000			
15. Value of transferor's estate (line 14 from line 9)	5,000,000			
16. Net Federal estate tax paid on transferor's estate	4,000,000			
17. Credit for gift tax paid on transferor's estate with respect to pre-1977 gifts (section 2012)				
18. Credit allowed transferor's estate for tax on prior transfers from prior transferor(s) who died within 10 years before death of decedent				
19. Tax on transferor's estate (lines 16, 17, and 18)	4,000,000			
20. Transferor's tax on prior transfers (line 7 / line 15)x line 19 of respective estates)	80,000			

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Worksheet for Schedule Q - Credit for Tax on Prior Transfers

Estate of: John Q. Sample SSN: 257-72-1464

Part II Transferee's tax on prior transfers

Item			Amount
21. Transferee's actual tax before allowance of credit for prior transfers (see instructions)			1,051,090
22. Total gross estate of transferee (from line 1 of the Tax Computation, page 1, Form 706)			19,776,986
23. Net value of all transfers (from line 8 of this worksheet)			100,000
24. Transferee's reduced gross estate (line 23 from line 22)			19,676,986
25 Total debts and deductions (not including marital and charitable deductions) (items 17, 18, and 19 of the Recapitulation, page 3, Form 706)		5,393,139	
26. Marital and Family-Owned Business Interest deduction (from items 20 and 22 of the Recapitulation, page 3, Form 706) (see instructions)		205,028	
27. Charitable bequests (from item 21, Recapitulation, page 3, Form 706)		10,688,570	
28. Charitable deduction proportion ([line 23 / (line 22-line 25)] x line 27)		74,310	
29. Reduced charitable deduction (line 28 from line 27)		10,614,260	
30. Transferee's deduction as adjusted (lines 25, 26, and 29)			16,212,427
31. (a) Transferee's reduced taxable estate (line 30 from line 24)			3,464,559
(b) Adjusted taxable gifts			
(c) Total reduced taxable estate (lines 31(a) and 31(b))			3,464,559
32. Tentative tax on taxable estate		1,498,434	
33. (a) Post-1976 gift taxes paid			
(b) Unified credit	345,800		
(c) Section 2011 state death tax credit	112,899		
(d) Section 2012 gift tax credit			
(e) Section 2014 foreign death tax credit			
(f) Total credits (lines 33(a) through 33(e))		458,699	
34. Net tax on reduced taxable estate (line 33(f) from line 32)			1,039,735
35. Transferee's tax on prior transfers (line 34 from line 21)			11,355

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