COMPLETING THE FORM 706 PUZZLE: AN OVERVIEW OF THE UNITED STATES ESTATE (AND GENERATION-SKIPPING TRANSFER) TAX RETURN

HARRY W. WOLFF III
Schoenbaum, Curphy & Scanlan, PC
112 East Pecan Street, Suite 3000
San Antonio, Texas 78205
210.224.4491
hwolff@scs-law.com

State Bar of Texas
INTERMEDIATE ESTATE PLANNING & PROBATE COURSE
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CHAPTER 3

HARRY W. WOLFF III

Schoenbaum, Curphy & Scanlan, P.C.
San Antonio, Texas

EDUCATION

- Georgetown University Law Center, LL.M. in Taxation, 2007
- University of Houston Law Center, J.D., 2006
- The University of Texas at Austin, B.S. in Public Relations, 2000

PROFESSIONAL ACTIVITIES

- American Bar Association
  - Member, Real Property, Trust and Estate Law Section
  - Member, Section on Taxation
- State Bar of Texas
  - Member, Real Estate, Probate and Trust Law Section
  - Member, Section on Taxation
- San Antonio Bar Association
- San Antonio Estate Planners Council
- SA Scene Magazine: Best Lawyers of 2011
- SA Scene Magazine: Rising Legal Star of 2013

PUBLICATIONS

- *Unilateral Economic Sanctions: Necessary Foreign Policy Tool or Ineffective Hindrance on American Businesses?*, *Houston Business and Tax Law Journal*, Volume 6.2.
- Co-Author with Amanda M. Gyeszly, *Corporate Issues Facing Estates*, South Texas College of Law 24th Annual Wills and Probate Institute, September 18-19, 2008.

PRESENTATIONS

- Presenter, State Bar of Texas Tax Section Webcast, *Trust Planning for S Corporation Shareholders*, August 7, 2008.
- Panelist, ACPEN Satellite Broadcast, *Fundamentals of S Corporations Practice*, November 19, 2008.
- Presenter, State Bar of Texas, State Bar College Summer School 2009.

Harry W. Wolff III is an attorney with Schoenbaum, Curphy & Scanlan whose practice includes taxation, estate planning and administration, exempt organizations and business law.

He is a member of the Sections on Taxation and Real Property, Probate and Trust Law of the State Bar of Texas and of the American Bar Association, the San Antonio Bar Association and the San Antonio Estate Planners Council.

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I. INTRODUCTION

For estate planning practitioners, the United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706, is often the last step in the attorney's relationship with a client, his or her family and team of advisors. In many cases, what started with a "get to know you" interview led to the practitioner preparing Wills, ancillary documents, trust agreements and/or partnership agreements, and perhaps many drafts and revisions of these documents over the years. It represents the culmination of the attorney's work, and as with all client engagements, it is one that can be made easier (or more complicated) based on the client's assets, transparency and cooperativeness.

In recent years, the ever-changing and uncertain nature of the estate tax exemption and rate regimes has impacted the number of estate tax returns the average practitioner prepares. On one hand, the increased exemption amounts have reduced the number of clients with taxable estates. Needless to say, most practitioners have more clients worth $1 – 2 million than those worth $4 – 5 million. However, our new found stability in the exemption and tax rates, combined with the new option of preserving a deceased spouse's unused exemption amount (DSUE), known as portability, has evened that out a bit. In fact, practitioners are now faced with the decision of whether or not to file a Form 706 in non-taxable estates for the sole purpose of "electing" in to portability. This choice

II. THE BASICS

This section covers the following questions:

- When a Form 706 must be filed?
- Who is responsible for filing the Form 706?
- Who is responsible for paying the tax?
- When the Form 706 is due?
- What are the consequences of late filing?
- When the tax is due?
- What are the consequences of late payment of tax?
- Where the Form 706 is filed?
- How the Form 706 is reviewed by the Internal Revenue Service ("IRS")?

A. Which Estates Must File Form 706?

A Form 706 must be filed if the date of death fair market value of the gross estate plus adjusted taxable gifts of a decedent who is a U.S. citizen or resident exceeds the exemption equivalent amount in effect for the year of death ($5,340,000 for decedents dying in 2014). (If the decedent is a nonresident alien and the fair market value of the gross estate exceeds $60,000, a Form 706-NA must be filed. IRC § 6018(a)(2)). For purposes of determining whether a return should be filed, alternate valuation date values and special use valuation values are disregarded. Treas. Reg. §20.6018-1(a), IRC §2032A.

1. Gross Estate

The decedent's gross estate includes the fair market value of all property owned by the decedent at the time of death to the extent provided for in Chapter 11. IRC §§2031 & 2033. Fair market value is determined based on the price the property would change hands between a [hypothetical] willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts. Treas. Reg. §20-2031-1(b).

Items included in the gross estate:

- Life insurance policies transferred and gift taxes paid within three years of the decedent's death. IRC §2035;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) in which the decedent retained a life estate, the right to income or the right, alone or in conjunction with any person, to determine possession or enjoyment of the transferred property. IRC §2036;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) taking effect upon the decedent's death. IRC §2037;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) in which the decedent at the time of death had the power to alter, amend, revoke or terminate. IRC §2038;
- Annuities and employee death benefits. IRC §2039;
- Joint tenant with right of survivorship property. IRC §2040;
- Property over which the decedent held a general power of appointment. IRC §2041;
- Life insurance proceeds payable to the decedent's estate or payable to other beneficiaries if the decedent held an incidence of ownership in the policy. IRC §2042;
- A transfer under IRC §§ 2035 – 2038 for less than adequate and full consideration in money or money's worth. IRC § 2043;

- Trusts for which a QTIP election was previously made in a deceased spouse's estate. IRC § 2044; and
- A power that would have caused inclusion in the decedent's estate under IRC §§ 2036, 2037, 2038 or 2042 that was relinquished by the decedent within three years of the decedent's death. IRC §2035.

2. Adjusted Taxable Gifts

The term "adjusted taxable gifts" means the total amount of the taxable gifts under IRC § 2053 made by the decedent after December 31, 1976, other than gifts that are includable in the gross estate of the decedent. IRC § 2001(b).

3. Valuation

The general rule for determining the value of assets in the decedent's estate is fair market value based upon a "willing buyer/ willing seller." Treas. Reg. §20.2031-1(b) provides additional guidance as follows:

> *Valuation of property in general*. – The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternative valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible 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. For example, the fair market value of an automobile (an article generally obtained by the public in the real estate market) includible in the decedent's gross estate is 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. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8. The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. 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. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 20.2031-3. See § 20.2031-2 and §§ 20.2031-4 through 20.2031-8 for further information concerning the valuation of other particular kinds of property. For certain circumstances under which the sale of an item of property at a price below its fair market value may result in a deduction for the estate, see paragraph (d)(2) of § 20.2053-3.

While a formal appraisal is not required for most assets, in many cases, it should be considered money well spent for the executor. Further, for many unique assets, it may be the only means of obtaining a true and representative fair market value for reporting purposes. Unfortunately, many executors (and/or family members) are reluctant, if not resistant, to the idea of obtaining an appraisal, viewing it instead as an unnecessary expense. Nevertheless, there are instances in which a formal appraisal is not only advisable, a necessity:

- When the beneficiaries desire to substantiate the new income tax basis in an asset or assets;
- When the estimated or approximate value of the decedent's gross estate is less than or exceeds the

applicable exemption amount by a small margin and the valuation of a particular asset (or assets) impacts the need to file a return;

- When the estate contains assets (or classes of assets) for which an appraisal is the only reliable method of obtaining a representative fair market value (e.g., collectables, artwork, etc.); and
- When conflict has arisen (or is likely to arise), among beneficiaries regarding an asset or assets (particularly in cases where there are unique or inconsistent pecuniary and specific bequests among the beneficiaries).

Once the decision to obtain an appraisal has been made, the preparer should then ensure that the appraiser and appraisals are appropriate for estate tax purposes. For example, Treas. Regs. Section 20.2031-1(b) requires that all appraisals for estate tax purposes define "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." While obvious, many appraisers overlook this point or otherwise miss the target on the fair market value. Common mistakes include the failure to include the aforementioned definition and/or the failure to properly value the property as of the decedent's date of death (or the alternate valuation date).

As described above, the Regulations under Section 2031 contain specific examples regarding the need for, and requirements of, appraisals of certain types of assets, such as closely-held business interests, live stock, crops and personal and household items.

Further, the gift tax Regulations provide guidance regarding the appraiser's qualifications, which include:

- The appraiser must be qualified to make appraisals of the type of property at issue by virtue of his or her background, experience, education and memberships in professional appraisal associations, if any;
- The appraiser holds himself/herself out to the public as an appeaser or performs appraisals on a regular basis; and
- The appraiser is not a member of the donor's family (or an employee of the donor's family. Treas. Regs. Section 301.6501(c)-1(f)

Thus, the decision to obtain the appraisal, and then the choice of the appropriate appraiser, are often among the most consequential decisions the preparer makes in completing the return. The old adage "you get what you pay for" is often applicable with appraisals, and while their cost can seem exorbitant at times, a properly prepared appraisal from a qualified and respected appraiser is critical to the completion of many returns.

4. Undervaluation Penalties

The usual late filing and/or payment penalties apply to filers of a Form 706. IRC §6651(a)(1) and (2). However, additional penalties apply for valuation misstatements on the Form 706. For example, IRC § 6662(a) imposes a penalty if the value of an asset is a "substantially misstated", or underreported by 65% or less of the correct value (as finally determined for estate tax purposes). In such cases, the penalty is 20% of the underpayment of tax! Further, the penalty increases to 40% of the underpayment if the reported value is a "gross understatement", or 40% or less of the determined value!

In addition, §6662(b)(1) imposes an additional 20% penalty in cases where the understatement is "negligent". The accompanying regulations under §1.662-3(b)(1) define "negligent" as:

- Failing to make a reasonable attempt to comply with the Code;
- Failure to establish a reasonable basis for an item in the return; and/or
- Failure to exercise ordinary and reasonable care in preparing the return, including the failure to substantiate items properly.

In many cases, the failure to commission and attach an appraisal to the Form 706 for certain assets would qualify as "negligence" and subject the taxpayer to the additional 20% penalty.

In 2007, IRC §6694 was expanded to include preparers of estate and gift tax returns in the prepare penalties! At the risk of stating the obvious, these penalties give the preparer a very real and vested interest in double-and triple-checking all valuations listed on the 706, particularly those for the "hard to value" assets listed on Schedule F, such as limited partnership interests and mineral royalties.

B. Who Must File Form 706?

1. Executor

The executor is responsible for preparing the Form 706. The term "executor" means the executor, personal representative, or administrator of the decedent's estate. If no executor, personal representative, or administrator is appointed, qualified and acting in the United States, every person in actual or constructive possession of any property of the decedent is considered an executor and must file a return. IRC § 2203.

Accordingly, if no probate proceeding is required due to the use of a revocable trust estate plan, the trustee of the trust is responsible for filing the return.

2. Co-Executors

If there is more than one executor, the co-executors should join in filing one complete return. All of the executors must sign the return under penalties of perjury and are liable for penalties provided for erroneous or fraudulent returns. IRC § 6061, Treas. Reg. §20-6061-1, Treas. Reg. §20-6018-2. The Instructions to Form 706 provide that "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. Who Must Pay Tax?

1. Executor

The executor is responsible and has fiduciary liability for paying any part of a debt of the decedent or the estate before paying a claim of the Government. IRC § 2002, U.S.C. § 371(b) 1994. Accordingly, the executor is personally liable for the taxes, penalties and interest if he or she: distributes assets of the estate; the distribution renders the estate insolvent; and the distribution took place after the executor had notice of the government's claim. *United States v. Coppola,* 85 F.3d 1015, 1020 (2nd Cir. 1996).

The statute of limitations for the executor's fiduciary liability is the ***later*** of: (i) one year after the liability arises; or (ii) the expiration of the period for collection of the tax. IRC § 6901(c)(3). However, a Federal District Court in Texas has ruled that if the failure of an executor to pay federal estate taxes is the result of fraud or defalcation, such obligation is not dischargeable in bankruptcy even though the executor is acting in a fiduciary capacity. *In re Daniel O. Tomlin, Jr.*, 88 AFTR3d Par 2001-5334, (N.D. Texas 2001). In short, the IRS has three years from the filing date in which to audit the return. The executor may choose to file a "Form 4810, "Request for Prompt Assessment under Internal Revenue Code Section 6501(d)" which has the effect of shortening the statute of limitations to eighteen months. However, doing so is virtually certain to result in increased scrutiny of the return, so this step should be taken only after thorough discussions between the executor and preparer.

As with the responsibility for filing the return, in the rare situation in which there is no executor, any person with actual or constructive possession of the decedent's property is responsible for the tax (including any applicable interest and penalties) to the extent of the value of the property.

D. When is the Form 706 Due?

Unless an extension is requested and granted, the Form 706 must be filed within nine months after the date of the decedent's death. IRC § 6075(a). The actual due date is the numerically corresponding day on the ninth calendar month after the decedent's death, and if there is no corresponding day in the ninth month, the last day of the ninth month. Treas. Reg. §§ 20-6018-2, §20-6075-1.

If the decedent dies in the United States, the date of the decedent's death is determined based on the time zone of the decedent's domicile. Rev. Rul. 66-85, 1966-1 C.B. 213, Rev. Rul. 74-424, 1974-2 C.B. 294. Accordingly, if the decedent dies away from home, the date of death on the death certificate could be different that the date of death for Form 706 purposes.

However, if a United States citizen dies in a foreign county of his domicile, the date and time of death are established in the foreign domicile at the moment of death. Rev. Rul. 74-424, 1974-2 C.B. 294.

If the due date falls on a Saturday, Sunday or legal holiday, the due date is the next day that is not a Saturday, Sunday or legal holiday. Treas. Reg. §20-6075-1. For Form 706 purposes, a legal holiday is defined as a legal holiday in the District of Columbia. IRC § 7503.

E. Extension of Filing Date

An executor is entitled to an automatic six month extension to file Form 706 under Treas. Reg. §20-6081-1(b), if Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes* is filed on or before the actual due date. ***Importantly, the full amount of estimated tax due must be filed with the Form 4768, unless an extension to pay the tax is granted under Treas. Regs. §§20-6161-1 and 20.6163-1.*** The date for filing the Form 706 cannot be extended for more than six months unless the executor is abroad.

If an extension to file the Form 706 is granted, but no extension to pay the tax is granted, interest and penalties will be due on any amounts not paid on or before the due date. Treas. Reg. §20-6081-1(e). Accordingly, the request for an extension to pay should be filed early enough to give the service sufficient time to make a determination on the request.

Note that even if the date for filing the Form 706 is extended, the time to make a timely qualified disclaimer under IRC § 2518 is not extended.

F. Place and Method of Filing

The Form 706 may be: i) hand carried to the office of the IRS District Director or an IRS office in the district where the decedent was domiciled, by the person required to file the return or his agent; ii) mailed to the IRS Cincinnati Service Center, Cincinnati, Ohio 45999; or iii) sent via a designated private delivery service to Internal Revenue Service Center, 201 W. Rivercenter Blvd., Covington, KY 41019. IRC §§ 6091(b)(3), 7502(f). Note: the Cincinnati Service Center is actually located in Kentucky!

A return sent by U.S. mail is deemed "filed" on the date of the United States postmark stamped on the cover in which such return is mailed, as such dated is deemed to be the date of delivery. IRC § 7502(a)(1). A postmark from a private postage meter is not conclusive proof. *Levinson Est. v. Commr. 39 T.C.M. 536 (1979).* Also, if the Form 706 is not mailed to the Cincinnati Service Center, it is not deemed to be filed until the earliest date it could have been received by transfer by the Cincinnati Service Center. *Winnett v. Commissioner*, 96 TC 802 (1991).

Clearly, best practice dictates filing the Form 706 by registered or certified mail, because the date of the registration or senders certificate is prima face evidence that the return was delivered, and the date of registration or sender's certificate shall be deemed to be the postmark date. IRC § 7502(c), Treas. Reg. §301.7502-1(c)(2). Accordingly, the risk that the document will not be postmarked on the day that it is deposited may be eliminated by the use of registered or certified mail.

Under IRC § 7502(f) which was added by the Taxpayer Bill of Rights 2, a return sent via a designated private delivery service is also covered by the timely mailed/timely filed rules set forth above. The Instructions to Form 706 state that "The private delivery service can tell you how to get written proof of the mailing date." The Instructions also provide that the designated private delivery services include only the following:

- DHL Express (DHL): DHL Same Day Service.
- Federal Express (Fed Ex): FedEX Priority Overnight, FedEX Standard Overnight, FedEx 2Day, FedEX International Priority, FedEx International First.
- United Parcel Service (UPS: UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus and UPS Worldwide Express.

G. When is the Tax Due?

The tax must be paid by the due date of the Form 706. IRC §6151. Importantly, as set forth above, if an extension to file the Form 706 is granted, such extension does not automatically extend the due date for the payment of the tax. Treas. Reg. §20-6081-1(e). Thus, any decision to extend (described in greater detail below), must be accompanied by a rough calculation of any tax due so that a payment can be made with the extension request (to avoid penalties and any unnecessary interest).

1. <u>Extension of Payment Date</u>

Unlike the extension to file which is "automatic" if timely filed, the payment due date can only be extended for "reasonable cause." Treas. Reg. §20-6161-1(a)(1). Reasonable cause includes:

- Liquid assets being located in other jurisdictions;
- The estate consist of assets which are rights to future payments such as royalties or annuities and loans cannot be obtained on terms that would not result in a loss the estate;
- The estate has a contingent claim the subject of litigation; or
- A lack of liquidity and loan cannot be obtained without causing a hardship loss the estate.

Treas. Reg. §20-6081-1(e). If reasonable cause is shown, the IRS can grant an extension for up to twelve months. IRC § 6161(a), Treas. Reg. §20-6161-1(a)(1).

The request for an extension of time to pay the tax is made on Form 4768, and as also set forth above should be filed so that there is sufficient time for the service to act on the request before the date the tax is due. The denial of an application to extend the due date for the payment of the tax can be appealed by writing to the IRS Regional Commissioner within 10 days of the mailing of the denial. Treas. Reg. §20-6161-1(b).

In addition to the reasonable cause extension under IRC § 6161(a), upon a showing of special reasonable cause that would constitute "undue hardship" the IRS can extend the payment date for a reasonable period up to 10 years. IRC § 6161(a)(2), Treas. Reg. §20-6161-1(a)(2). This generally will be shown when the estate consists of an illiquid asset that will not qualified for installment payments under IRC § 6166 and the asset must be sold in order to pay the tax.

If the gross estate includes a reversionary or remainder interest in property, the payment of the part of the tax attributable to such interest may at the election of the executor postponed until 6 months after the termination of the preceding interest or interests in the property. IRC § 6163.

2. <u>Installment Payments</u>

Under IRC § 6159(a) the IRS is authorized to enter into written agreements with any taxpayer allowing such tax payer to make payment on any tax in installment payments if such agreement will facilitate full or partial payment of such liability. Qualification for installment payments of the tax under IRC § 6166 when a sufficient percentage of the estate consists of closely held business interests.

3. <u>Place and Method of Payment</u>

The rules cited above regarding the place and method of filing the Form 706 also apply to the payment of the tax. Though the tax is generally paid by check or money order (the only method used by the author), IRC § 6311(d) provides for payment by credit or debit card, and IRC § 6302 provides for payment by electronic transfer. The check should be payable to the "United States Treasury", and should include the decedent's name and social security number and notation "Form 706" in the notation line.

4. Failure to Timely Pay Tax

The failure to timely pay the tax will result in liability for penalties and interest.

If the amount of tax shown on the Form 706 is not paid on or before the date prescribed for payment, (determined with regard to any extension of time for payment) unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount of tax due an additional 0.5 percent of the amount of such tax, if the failure is for one month or less, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent. IRC § 6651(a)(2). In order to satisfy the reasonable cause requirement, the executor must show that he exercised ordinary business care and prudence in providing for payment of the tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if the tax was to be paid on time. Treas. Reg. §301.6651-1.

If any amount of tax shown on the Form 706 is not paid on or before the last date prescribed for payment, interest on such amount shall be paid from the due date through the date paid. IRC § 6601(a). The interest rate is the Federal short-term rate as determined under IRC § 6621(b)(2) plus 3 percentage points. (IRC § 6621(a).

H. How is the Estate Tax Computed?

The decedent's gross estate includes the fair market value of all property owned by the decedent at the time of his death to the extent provided for in Chapter 11. IRC §§2031 and 2033. Fair market value is determined based on the price the property would change hands between a [hypothetical] willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts. Treas. Reg. §20-2031-1(b).
Items included in the gross estate:

- Life insurance policies transferred and gift taxes paid within three years of the decedent's death. IRC §2035;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) in which the decedent retained a life estate, the right to income or the right, alone or in conjunction with any person, to determine possession or enjoyment of the transferred property. IRC §2036;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) taking effect upon the decedent's death. IRC §2037;
- Transfers during the decedent's life (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) in which the decedent at the time of death had the power to alter, amend, revoke or terminate. IRC §2038;
- Annuities and employee death benefits. IRC §2039;
- Joint tenant with right of survivorship property. IRC §2040;
- Property over which the decedent held a general power of appointment. IRC §2041;
- Life insurance proceeds payable to the decedent's estate or payable to other beneficiaries if the decedent held an incidence of ownership in the policy. IRC §2042;
- A transfer under IRC §§ 2035 – 2038 for less than adequate and full consideration in money or money's worth. IRC § 2043;
- Trusts for which a QTIP election was previously made. IRC § 2044; and
- A power that would have caused inclusion in the decedent's estate under IRC §§ 2036, 2037, 2038 or 2042 that was relinquished by the decedent within three years of the decedent's death. IRC §2035.

1. Taxable Estate

The taxable estate is determined by subtracting the applicable deductions from the gross estate. Treas. Reg. §20.0-2(b)(3).
Allowable deductions include:

- Expenses, debts and taxes. IRC §2053;
- Assets lost, stolen, or destroyed during the course of estate administration; to the extent such losses are not compensated by insurance. IRC §2054;
- Unlimited deduction for qualifying charitable bequests. IRC §2055;
- Unlimited deduction for qualifying transfers to the decedent's spouse. IRC §2056; and
- Estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia. IRC §2058.

2. Tentative Estate Tax Base

The value of the adjusted taxable gifts is added to the taxable estate to determine the tentative estate tax base against which the rate schedule under IRC §2001 is applied to compute the tentative tax. The term adjusted taxable gifts means the total amount of the taxable gifts under IRC § 2053 made by the decedent after December 31, 1976, other than gifts that are includable in the gross estate of the decedent. IRC § 2001(b).

3. Estate Tax Due

Gift taxes paid on taxable gifts made after 1976 and credits against the estate tax to which the estate is entitled are deducted from the tentative tax to arrive at the amount of estate tax due. Credits to which the estate is entitled includes:

- The applicable credit amount. IRC §2010;
- Credit for state death taxes [pre 2005]. IRC §2011;
- Credit for pre-1977 gift taxes on property included in the gross estate. IRC §2012;
- Credit for taxes on prior transfers. IRC §2013; and
- Credit for foreign death taxes. IRC §2014.

I. IRS Review of Form 706

Unlike a Form 1040 which is only hand-reviewed on a arbitrary and random basis, each Form 706 is thoroughly reviewed at the IRS Cincinnati campus by Federal Estate and Gift Tax Agents, all of whom are attorneys, CPAs (or in some cases, both). Accordingly, the odds that a Form 706 will be selected for audit are much higher than in the case of Form 1040.

Part 2 of Form 706 includes an authorization for one attorney, accountant or enrolled agent to act as the estate's representative before the IRS; and to make written or oral representations on behalf of the estate if the return is prepared by an attorney, accountant or enrolled agent. To authorize more than one person to act on behalf of the estate a Form 2848 must be completed and filed. Form 2848 is also required to authorize persons other than attorneys, accountants or enrolled agents to act as agent and to authorize a person to enter into closing agreements for the estate.

1. The Estate Tax Closing Letter

Upon the conclusion of the IRS review (either upon the initial review or following an audit), the IRS will issue an "estate tax closing letter" to the executor, by which, the Service either accepts the return as filed, or is accepted after an adjustment. While not a formal closing agreement under §7121 (which is a final and conclusive determination by the IRS of a taxpayer's liabilities), upon receipt of the closing letter, the executor is free to proceed with the closing of the probate estate and full funding of the testator's estate, knowing that (barring extenuating circumstances described below) the estate has no additional federal tax liabilities. Generally speaking, the IRS will not reopen an estate and make an additional adjustment to the return unless:

- There is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact;
- The prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or
- Other circumstances exist that indicate failure to reopen would be a serious administrative omission. Rev. Proc 94-68, 1994-2.

III. THE FORM 706 ITSELF

A. General Considerations

In many cases, the preparation of the Form 706 represents the final step in the practitioner's representation of a client and/or family. What started as an informational meeting with the client to discuss estate planning matters let to an engagement letter and the preparation of a Will, ancillary documents and/or trust agreements (and possibly multiple revisions thereof). (If nothing else, a comfort level with the requirements of the 706 is beneficial to the practitioner in that our advice and documents can be crafted with the "end game" in mind.) In these cases, the preparer is usually familiar with the client's occupation, family history and has at least a general idea of his or her assets and investments. This familiarity is clearly advantageous in implementing a plan for the preparation and completion of the Form 706, and often allows for preliminary steps to be taken shortly after the client's death. In other cases, however, the practitioner may not be as familiar with the client or his or her estate plan, and may need to bring himself or herself up to speed and develop a relationship with the executor and the client's team of advisors. In this situation, it may be several months since the client passed away and result in an expedited time table for the preparation of the return.

Either way, the approach and considerations are the substantially the same. While numerical data and tax calculations are ultimately what we (and the IRS) will focus on, the supporting documents and explanatory attachments required in the Form 706 make it a much more complicated return than the average Form 1040 or 1041. In fact, as in many aspects of a legal practice, the presentation is critical, and in the author's opinion, the clear, concise and organized presentation is equally important as the collection and accuracy of the data entered into the various schedules.

B. Part 1 – Decedent and Executor

While this section is fairly self-explanatory, I have briefly described a few of the questions asked in Part 1 below.

1. <u>Lines 1a and 1b: Decedent's Name:</u>

In situations where a decedent had nicknames or was known by multiple names during his or her lifetime, the name used by the decedent in the filing of his or her income tax returns should be used here for consistency's sake. If, however this name differs substantially from that used in the Will or other documents (bank statements, trust agreements, etc.) it is often advisable to include a brief explanation of any such discrepancies.

2. <u>Line 2. Social Security Number:</u>

If the decedent did not have a social security number, the instructions dictate that the executor obtain one on his or her behalf for reporting on the Form 706.

3. <u>Line 3a. Decedent's Legal Domicile:</u>

Because the laws of the jurisdiction in which the decedent was domiciled will control, this information may be important in determining the characterization of property (i.e., as community or separate).

4. <u>Line 3b. Year Domicile Established:</u>

Often times, the executor or preparer is tasked with an "Easter egg hunt" for personal or family information that is not otherwise readily available. Line 3b is one of those questions. While it may not be difficult to ascertain or otherwise impact the return, it may be important in determining the characterization of property as community or separate.

C. Part 2 – Tax Computation:

Despite being the first page starting us in the eyes as we look at the Form 706, and Line 20 being what caches our clients' collective eyes,, the tax computations are basically the last detail we attend to in preparing the 706. It is clearly the most technical section of the return, but fortunately, software programs provide many of us assistance in making many of these computations. That said, we all need to double-check the calculations, and those of us who plan to sit for the Texas Board of Legal Specialization exam, must know how these calculations fit together!

1. <u>Line 1: Total Gross Estate Less Exclusion:</u>

This amount comes from Line 13 of the Recapitulation in Part 5 (the total gross estate less any qualified conservation easement exclusions from Schedule Q). In short, if this number exceeds the filing threshold ($5,340,000 for 2014), then a Form 706 must be filed for the decedent's estate.

2. <u>Line 2: Tentative Total Allowable Deductions:</u>

This entry is Line 24 from the Recapitulation in Part 5.

3. <u>Line 3a: Tentative Taxable Estate</u>

The tentative taxable estate is reported on Line 3c, and calculated by subtracting the value of the total deductions on Line 2 from the total gross estate on Line 1.

If decedent paid any state inheritance taxes, these amounts are properly reported on Line 3b.

4. <u>Line 4 Adjusted Taxable Gifts:</u>

In order to complete Line 4, the preparer must determine whether the decedent made any taxable gifts during his or her lifetime, and if so, whether the appropriate Forms 709 were filed. Once this determination has been made, the total adjusted taxable gifts made by the decedent after December 31, 1976 are to be listed in Line 4.

5. <u>Line 6 Tentative Tax:</u>

Table A from the Form 706 Instructions (attached below), shows how the tax is calculated.

TABLE A – UNIFIED RATE SCHEDULE
From Form 706 Instructions

Column A Taxable Amount Over	Column B Taxable Amount Not Over	Column C Tax on amt. in Column A	Column D Tax rate on excess over Column A
-	$10,000.00	-	18%
$10,000.00	$20,000.00	$1,800.00	20%
$20,000.00	$40,000.00	$3,800.00	22%
$40,000.00	$60,000.00	$8,200.00	24%
$60,000.00	$80,000.00	$13,000.00	26%
$80,000.00	$100,000.00	$18,200.00	28%
$100,000.00	$150,000.00	$23,800.00	30%
$150,000.00	$250,000.00	$38,800.00	32%
$250,000.00	$500,000.00	$70,800.00	34%
$500,000.00	$750,000.00	$155,800.00	37%
$750,000.00	$1,000,000.00	$248,300.00	39%
$100,000.00	-	$345,800.00	40%

6. Line 7: Total Gift Tax Paid or Payable:

Any gift taxes paid by the decedent on or after January 1, 1976 are entered on Line 7. Any amounts entered are deducted from the tentative estate tax (listed on Line 6 above) and act as a credit for prior gift taxes paid. Lines, 8a, 8b and 8c in Part 4 of the Form 706 request information regarding previously filed gift tax returns (Forms 709).

7. Line 8: Gross Estate Tax:

The gross estate tax is the estate tax liability prior to any credits.

8. Lines 9a – 9d. Applicable Credit Amount (Formerly Unified Credit Amount):

When contemplating a decedent's estate tax liability (or gift tax liability for inter vivos gifts) most immediately think of the "exclusion amount", with many thinking that the estate tax applies to any excess. However, the exemption amount is actually translated into a credit against estate (or gift) taxes, which is then applied against the decedent's gross estate. Thus, the $5,340,000 exemption actually translates into a $2,081,800 credit against estate taxes. Formerly called the "unified credit", this amount is now referred to as the "applicable credit amount". The "applicable exclusion amount" is the sum of the basic exclusion amount in Line 9a plus the deceased spousal unusual exclusion amount (DSUE) if any, listed on Line 9b.

9. Line 9a: Basic Exclusion Amount:

The basic exclusion amount for 2014 (as adjusted for inflation in 2014 under IRC § 2010(c)(3) is $5,340,000.

10. Line 9b: Deceased Spousal Unused Exclusion (DSUE) Amount from Predeceased Spouse(s) from Part 6:

If the decedent had a spouse who died after December 31, 2010, the deceased spousal unused exclusion (DSUE) is carried over and reported here. (This is the amount calculated on Sections C and D on Part 6.)

11. Line 9(c): Applicable Exclusion Amount:

The applicable exclusion amount is determined by adding the basic exclusion amount, with any applicable DSUE amount (i.e, Lines 9a and 9b).

12. Line 9(d): Applicable Credit Amount:

The applicable credit amount is determined by calculating the tax on the applicable exclusion amount listed in Line 9c (using the Table A from the Instructions, also listed above).

13. Line 10: Adjustment to Applicable Credit Amount:

An adjustment on line 10 is only made if the decedent made gifts after September 8, 1976 and before January 1, 1977, for which a separate exemption was used for certain taxable gifts.

14. Line 11: Allowable Applicable Credit:

If an adjustment to the applicable credit amount is made in Line 10, this amount is deducted from Line 9(d) to determine the applicable credit amount. In most cases, Line 11 will be a carryover of the amount listed on Line 9d.

15. Line 13: Credit for Foreign Death Taxes:

If any foreign death or succession taxes were paid, the credits calculated on Schedule P are carried over here.

16. Line 15: Total Credits:

The sum of any credits claimed for foreign succession taxes paid (Schedule P) and/or for prior transfers made (Schedule Q) is listed on Line 15.

17. Line 17: GST Taxes Payable:

If any generation-skipping transfer (GST) taxes are payable, the amount from Line 10 on Schedule R, Part 2 are listed here.

18. Line 19. Prior Payments:

As described above, even if a timely filed extension request is filed, the applicable transfer taxes are due on the original due date. As such, it is always advisable when possible to make a payment with such extension request. In addition to listing these payments on Line 19, a copy of the Form 4768 and check for the prior payment should be included as an attachment.

19. Line 20: Balance Due (or Overpayment):

If, after a prior payment made with the extension, a refund is due, this amount will be listed on Line 20.

D. Part 3 – Elections by the Executor

1. Line 1: Alternate Valuation Date Under Section 2032:

Section 2032 gives the executor the option of valuing the assets of the estate at their fair market value six months from the decedent's date of death (instead of at their date of death value). This provision is intended to protect beneficiaries of estates which may decline in value in the months following the decedent's death.

The election is an "all or nothing" decision, in that it applies to each and every asset reported on the return. (Any assets sold in the intervening six-month period are to be reported at the sales price.) IRC § 2032(a).

This election is made by selecting "yes" on line 2, page 2, Part 3. Similarly, the value of each asset on the corresponding schedules of the Form 706 must be valued as of the alternate valuation date and reported accordingly in each Schedule.

2. Line 2: Section 2032A Special Use Valuation:

Under Section 2032A, the executor may elect to have certain real property used in a small business or for farming purposes at its "Farm or business use" value, rather than its fair market value. This provision is designed to "save" the family farm from a forced sale to cover estate taxes, particularly when the property is located near a major metropolitan area or in an a market with substantial development. In those cases, its value for farming purposes is substantially less than as a prime new subdivision development.

Generally, the following requirements apply:

- The real estate must be located in the United States;
- The decedent must be a U.S. resident or citizen;
- The real estate must have been implemented for the qualified use on the decedent's death (by the decedent or a family member);
- The real estate must pass to a qualified heir of the family member; and
- 50 % or more of the adjusted value of the gross estate must consist of qualified real estate or qualified personal property and 25% or more of the adjusted value of the gross estate must consist of qualified real estate. IRC §2032A(1)(2).

To make the election, the executor must select "yes" on Line 2, Page 2 on Part 3 and complete Schedule A-1. Importantly, the election requires that the preparer obtain two valuations of the property- one for its 2032A special use, and another at its fair market value. This makes two separate appraisals a necessity, which must be budgeted for financially and in the timetable for preparing the return.

3. Line 3: Section 6166 Installment Payments:

IRC § 6166 provides an extension of time to pay estate and generation-skipping transfer (GST) taxes attributable to closely-held business interest. Specifically, §6166 provides that any such payments may be deferred for up to five years after the decedent's death, after which the amount may be spread out into up to ten (10) annual payments.

In order to qualify for the 6166 exclusion, (i) the decedent must be a U.S. citizen or resident; and (ii) the value of the estates interest in the closely help business must exceed 35% of the gross estate.

In order to make this election, the executor checks the applicable box on Part 3, page 3, and must attach a "Notice of Election" containing the following items:

- The decedent's full name and social security number;
- The amount of tax to be paid in installments;
- The date of the first installment;
- The number of annual installments;
- Identification of the §6166 property on the Form 706 schedules; and

A narrative description supporting the executor's request for §6161 relief should also be included, and should set out the estate's need for such relief in detail.

Note: As a practical point, it is generally advisable to request 10 annual payments because, while the estate could always pre-pay the remaining balances, the number of installment payments may not be increased once granted. Treas. Regs §20.6166-1(b) and (d).

4. Line 4: Postponement of Tax on Reversionary or Remainder Interests Under Section 6163:

Section 6163(a) gives the executor the option of electing to pay the estate tax attributable to reversion or remainder interests included in the gross estate until six months after such interest becomes possessory to the estate or the decedent's heirs.

E. Part 4 – General Information

1. Authorization of Representative

The initial portion of Part 4 provides for the designation of attorney, accountant, or enrolled agent to represent the estate before the IRS. Though this seems routine, the designation of the agent should be determined based upon any potential issues that could be the subject of an audit of the Form 706.

Issues to consider include the status "privileges" that the representative has with the estate and a determination of their non-waiver, both past and present. A plan should also be put in place as to the initial response to an examination or request for additional information.

2. Part 4, Questions 1 – 16

- Question 1 requires an original of the decedent's death certificate. Again, while this seems like a routine request, and is an item that is routinely collected at the onset of an engagement for probate purposes, the preparer should always ensure that an original is saved in the file for this purpose. Given that 9 (or perhaps 15) months have elapsed since the decedent's death and the initial receipt of the death certificate, these documents are easily misplaced (or returned to the executor for use in claiming a non probate asset such as an annuity or life insurance policy). In addition, the "Supplemental Documents" section requires that a ***certified*** copy of a testate, U.S. citizen decedent's Will be included with the Form 706 (or if unavailable, an explanation of why a certified copy is not or cannot be included with the return). As such, the preparer should ensure that these documents are obtained and set aside in advance of the due date to avoid any "mad scrambles" leading up to the due date.

- Question 2 regarding the decedent's business or occupation is generally not problematic and does not require furnishing any additional information.

- Questions 3, 4a, 4b and 4c, regarding the decedent's marital status are not (or should not be) problematic. If the decedent was divorced on the date of death you must provide the date the divorce decree became final, and if married at the time of death, the spouse's full name and social security number. **Note:** Despite the seemingly straight-forward nature of this inquiry, the preparer should obtain this information as soon as possible. Consider the elderly decedent who was widowed and/or divorced (perhaps multiple times) and subsequently remarried. Will the surviving spouse (who may also have been widowed and/or divorced as well) have access to the specifics of the deceased spouse's marital history? Further, will the decedent's children or other relatives?

- Question 5 requires a listing of all non-charitable beneficiaries and the amount of the decedent's estate each is to recieve. This includes trusts, which often are funded with amounts based upon tax driven/sensitive formulas.

- Question 6 inquires about whether the estate is filing a protective claim for a refund (described in greater detail below).

- Question 7 inquires about QTIP property which the decedent received from his or her spouse. This question requires a review of the predeceased spouse's estate documentation.

- Questions 8a, 8b and 8c require copies of all gift tax returns files by the decedent.

- Questions 9a and 9b require disclosure of any life insurance on the decedent's life, or any life insurance the decedent owned on the life of another that is not included in the gross estate. If either of these question is answered "yes" you should be ready to produce documentation supporting the non-inclusion such as trust agreements, "Crummey" letters and other relevant information.

- Question 10 inquires about property the decedent owned jointly with someone other than his or spouse of which less than the full value of the property is included in the gross estate. If this question is answered yes, the preparer should be ready to produce documentation to support such non-inclusion.

- Questions 11a and 11b inquire about the existence of closely held entities (i.e. family limited partnerships, limited liability companies, etc.) and whether the value of any such entities was "discounted." Any affirmative answer to these questions is likely to result in an examination and/or request for additional information. The preparer should carefully review all information regarding the formation, funding and operation of the entities and advise the client of the potential audit.

- Question 12 inquires about transfers under IRC §§ 2035, 2036, 2037 and 2038. An affirmative response requires the completion of Schedule G, which will be discussed in greater detail below.

- Questions 13a – 13e inquire about any trusts created by the decedent during his or her lifetime which are in existence at the time of the decedent's death, and require the attachments of copies of such trusts. Question 13e inquires about gifts or sales of closely held business interests to "intentionally defective grantor trusts" (otherwise commonly referred to as an "IDGT"). A brief explanation of the technique follows:

> An IDGT is a trust that is created to avoid inclusion of the assets transferred to the trust (by gift or sale) in the grantor's estate for federal transfer tax purposes, but is treated as a grantor trust for federal income tax purposes by virtue of the differences between the estate tax inclusion rules under IRC §§ 2036-2042 and the grantor trust income tax rules IRC §§671-678.
>
> Triggering grantor trusts status results in the trust being disregarded for federal income tax purposes (the so called defect). In actuality, there is no "defect"

in that the drafter desires grantor trust income tax treatment.

Under an IDGT, the grantor must report on his or her federal income tax return all income, deductions and credits attributable to the trust's property. The payment of the tax on the trust income does not constitute a gift by the grantor under Rev. Rul. 2004-64, which further depletes the grantor's estate. This ruling, which is the foundation for planning with an IDGT goes on to provide that such non-gift treatment only applies if the grantor has no legal right under the trust instrument or state law to be reimbursed for such payments.

- Question 14 inquires about the decedent's possession, exercise or release of a general power of appointment. To respond to this question, the preparer must review the relevant document creating a power of appointment in favor of the decedent, and an affirmative answer requires the completion of Schedule H.

- Question 15 inquires about any financial accounts owned by the decedent in a foreign country.

- Question 16 asks whether the decedent immediately before his or her death was receiving an annuity or a private annuity. Of particular interest to the IRS in this question would be the receipt of a private annuity (PA), which is a technique often, used when a person has reduced life expectancy. A brief explanation of the technique is included in the discussion of Schedule I below.

- Question 17 asks if the decedent was the beneficiary of QTIP trust for which the marital deduction was claimed in the estate of a pre-deceased spouse, and such trust is not reported on the Form 706. An affirmative response requires an explanation of why the trust is not reported on the return.

As described above, the instructions require the following documents be attached to Form 706:

- A certified copy of the decedent's will;
- Form 712 Life Insurance Statement, for each policy on the decedent's life; and
- State certification of payment of death taxes (if applicable).

Note: In many cases, the beneficiaries will have cashed in life insurance policies on the decedent's life before starting the 706 process (or in the early stages thereof) or assume that as a non-probate asset, it is not included in the decedent's estate. As such, these assets often fall into the "out of sight, out of mind" category for many executors. Accordingly, practitioners should encourage the executor(s) to request and obtain the Form 712.

F. Part 5 – Recapitulation

Part 5 (page 3) of the 706 is the "summary" of decedent's gross estate and contains the total of the assets reported on Schedules A through I. These values are carried over from the respective schedules and listed on Lines 1 through 9. In addition, the total deductions claimed in Schedules J through O are also reported in Part 5 and listed on Lines 14 through 22. The values of the gross estate (reported on Line 14 and the total deductions (Line 24) are then carried over to the Tax Computation in Part 2, and reported in Lines 1 and 2, respectively.

G. Part 6 – Portability of Deceased Spousal Unused Exclusion (DSUE)

On January 2, 2013, President Obama signed into law the American Tax Relief Act of 2012 (commonly referred to as "ATRA"). From an estate tax perspective, ATRA essentially made permanent most of the key estate planning provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which was passed on December 17, 2010 and was made retroactive for all of 2010, but was effective only through December 31, 2012). While the permanent $5,000,000 (indexed for inflation and currently $5,340,000) applicable exclusion amount and increased maximum tax rate (40%) garnered the most attention, the newly-created portability of this applicable exclusion amount between spouses is often overlooked.

1. <u>What is Portability?</u>

In short, portability allows a deceased spouse's executor to transfer his or her unused applicable exclusion amount (commonly referred to as the "DSUE" amount) to the surviving spouse, who is then free to use it as if it were his or her own. Importantly because both of the applicable laws provide that the applicable exclusion amount is applicable to lifetime transfers and transfers at death, the exemption amount is available to the surviving spouse to make lifetime gifts.

Previously, planning to fully utilize both spouses' exclusion amounts required the use of a "bypass" or "credit shelter" trust, to which the deceased spouse's exemption amount would be applied. While this technique is still very much a part of our toolbox for non-tax reasons, it was not 100% effective in situations where the deceased spouse did not fully utilize his or her exemption. For example, consider a decedent who passed away in 2009 (when portability did not exist and the applicable exclusion amount was $3,500,000) with a taxable estate of $2,250,000. The credit shelter trust would be funded with $2,250,000 of property and an equivalent amount of his exclusion amount would be applied to the trust. While any future appreciation in the assets transferred to the credit shelter trust would remain exempt from estate taxes in the future, the unused $1,250,000 was not available to the surviving spouse for his or her use in the future.

Accordingly, the emergence of portability has provided a powerful new option for practitioners and their clients. At the same time, it creates a new set of considerations and risks for those of us who represent the executor and/or surviving spouse of a decedent with a non-taxable estate. In some cases, it may be evident that the surviving spouse is the monied spouse. If he or she has a substantial amount of separate property, the decision to "elect in" is an easy one. However, in many cases, we have no idea whether the surviving spouse's current assets (or future investments) are likely to appreciate, or if he or she is likely to come into a sizeable inheritance. Even more difficult to predict is what the applicable estate tax laws will be at the time of his or her death! While most agree that our current estate tax laws represent the most stable climate we have experienced in the past ten to fifteen years, our crystal balls are far from clear. (Most of us did not expect to see the reunified $5,000,000 estate and gift tax exemptions, not to mention portability, in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010!)

2. <u>Effects of Remarriage</u>

The DSUE amount available for use by the surviving spouse is limited to the lesser of $5,340,000 (2014) and the unused exclusion of the *last deceased spouse*. "Last deceased spouse" is defined as "the most recently deceased individual who was married to the surviving spouse at that individual's death". §§ 20.2010-1T(d)(5), 20.2010-3T(a)(3) and 25.2505-2T(a)(3). In other words, a subsequent remarriage and/or divorce by the surviving spouse does not preclude the surviving spouse from using a former spouse's DSUE amount.

3. <u>How Do I Elect into Portability?</u>

In order to elect portability of the DSUE amount, the executor of the deceased spouse's estate must timely file a complete Form 706. Specifically, this election is made on Part 6 on page 4. Generally speaking, the DSUE amount available to the surviving spouse will be the lesser of the basic exclusion amount on line 9a of Part 2 and the excess of the decedent's applicable exclusion amount over the sum of the (i) decedent's taxable estate and (ii) the amount of the decedent's adjusted taxable gifts.

IV. FORM 706 SCHEDULES

A. Schedule A – Real Estate

Any real estate interests owned by the decedent in his or her sole name (or a fractional share owned as community property or as a tenant in common) are to be included on Schedule A. This includes raw land (including any improvements/fixtures theron or attached thereto), easements, fractional interests, interests in sales contracts, accrued rentals and mineral interests. (Practitioner's Point: While mineral interests are properly listed on Schedule A, royalty interests are properly reported on Schedule F under miscellaneous property. Joint tenancy property is properly reported on Schedule E (Jointly Owned Property).

Real Property should be described in sufficient detail so that it is readily identifiable by the IRS.

B. Schedule A-1 – Section 2032A Valuation

As described above in the description for Part 3, the executor may elect to have certain real property used in a small business or for farming purposes valued at its value for farming or business purposes, rather than at its fair market value. As an example, suppose the decedent owned and operated a farm on his family's property just outside the city limits of a growing urban area. While the property might be worth $2,500,000 to a developer with plans to build a subdivision on the property, its value is $1,700,000 to the farmer operating his or her business. Schedule A-1 would be used to report the real property at this reduced value.

Note: For 2013, the difference between the fair market and special use values for any such property may not exceed $1,070,000.

In order to qualify under this section, the following conditions apply:

1) the decedent must have been a U.S. citizen or resident at the time of his death;
2) the real property must be located in the United States;
3) at the time of the decedent's death, the real property must have been used by the decedent or a family member for farming (or in a trade or business) or was rented for such used by the surviving spouse or a lineal

descendant of the decedent to a family member on a net cash basis;

4) the real property was acquired from, or passed from the decedent to a qualified heir of the decedent;
5) the real property was owned and used in a qualified manner by the decedent or a member of the decedent's family during 5 of the last 8 years before the decedent's death;
6) the decedent (or a member of his family) materially participated in the business or farm in 5 of the 8 years leading up to the decedent's death;
7) at least 50 % of the adjusted value of the gross estate must consist of the adjusted value of the special use value and at least 25% of the adjusted value of the gross estate must consist of the adjusted value of the qualified farm or the closely-held business real property.

C. Schedule B – Stocks and Bonds

Stocks and bonds (i) owned by the decedent as his or her separate property; (ii) owned as a tenant in common; and/or (iii) as community property, are to be reported on Schedule B. For stocks, each entry should include:

1) the number of shares;
2) the classification of stock (i.e., common or preferred);
3) issue; par value (if needed for identification);
4) the applicable price per share;
5) the full name of the corporation;
6) the principal exchange upon which sold, if applicable; and
7) the nine-digit CSIP Number. (The "Committee on Uniform Security Identification Procedure", or "CUSIP" number is a 9 digit number assigned to all publicly-traded stocks and bonds.

It is generally listed on the face of the stock certificate or can be obtained by the broker or custodian.) For bonds, each entry should include:

i) the quantity and denomination;
ii) the name of the obligor;
iii) the date of maturity;
iv) the interest rate;
v) the interest due date;
vi) the principal exchange (if applicable); and
vii) the nine-digit CUSIP number.

If a particular stock or bond is unlisted, the company's principal business office should be listed.

D. Schedule C- Mortgages, Notes and Cash

Schedule C lists any mortgages or notes payable to the decedent, and/or cash owned by the decedent at his or her date of death. These items should be listed in the following order:

1) mortgages;
2) promissory notes;
3) contracts by decedent to sell land;
4) cash in possession; and
5) cash in banks, savings and loan associations and other types of financial organizations.

Descriptions of mortgages and promissory notes must include:

i) the face value;
ii) unpaid balance;
iii) date of mortgage;
iv) name of the maker;
v) property mortgaged;
vi) maturity date;
vii) interest rate;
viii) interest date.

Descriptions of contracts by the decedent to sell land should include:

1) the name of the purchaser;
2) a property description;
3) the sales price;
4) initial payment(s);
5) installment payment amounts (if any);
6) unpaid principal balance; and
7) the interest rate.

Cash on hand (such as cash in the decedent's home or safe) should be listed separately from cash held in banks, savings and loan associations or other financial institutions. Descriptions of cash accounts should include (i) the name and address of the financial organization; (ii) the amount in each account; (iii) the account number (iv)the type of account (checking, savings, etc.) and (v) any unpaid or accrued interest.

Note: the preparer should always review the applicable statements for several months after the decedent's death, to determine whether any checks written on or before the decedent's death were subsequently cashed, which might require an adjustment in the date of death balance.

While inclusion of the statements in the return is not required, it is often advisable since the executor/preparer would have retained them in case of examination anyway.

Each stock or bond should be valued at its fair market value on the valuation date, which is the average of the highest and lowest sales prices on that particular date.

Valuation Considerations: While cash is very easily valued, mortgages and notes are less so. Treas. Reg. §20.2031-4 provides:

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, satisfaction 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 notes is uncollectable, 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 mortgaged as security is insufficient to satisfy the obligation.

Needless to say, many notes and mortgages are worth less than face value, and in these cases, the executor will clearly want to "establish that the value is lower or that the notes are worthless". In those cases, an appraisal is likely the most prudent means of doing so.

E. Schedule D: Insurance on the Decedent's Life

IRC § 2042 provides that life insurance policies on the life of the decedent are includible in his or her gross estate if (i) the proceeds are payable to the decedent's estate and/or (ii) if the decedent possessed any "incidents of ownership" over the policy.

However all insurance policies on the decedent's life (regardless of inclusion in the decedent's gross estate), must be reported on Schedule D of the 706.

The description on Schedule D should include the insurance company name and policy number. The policy should be valued based on the value shown on the Form 712- Life Insurance Statement which is obtained from the insurance company. The Form 712 includes the face value of the policy, any accumulated interest and dividends and/or any other additional benefits or unearned premiums, and should be included in the Form 706 as an attachment to Schedule D.

F. Schedule E: Jointly Owned Property

Any joint property interests which are "payable on death" or registered as "right of survivorship" are properly reported on Schedule E. This includes bank accounts, real property, stocks, bonds or other personal property in which the decedent held title (automobile, boat, recreational vehicle, etc.) or other assets which would otherwise be reported on other schedules on the return.

Joint property owned by the decedent and his or her spouse is reported in Part I. Any such property should be reported at full value in Line 1(a), with the decedent's one-half interest reported on line 1(b).

Non-spousal joint property interests are reported on Part II. Under IRC § 2040, the full value of any such property should be reported unless the preparer can provide evidence of the other joint tenant's ownership and/or contributions to the property. IRC §2040(b); Treas. Regs. §20.2040-1(b). This creates additional work with respect to property owned by persons other than the surviving spouse, in that the executor must not only substantiate the other owner's (or owners') respective ownership interests, but also distinguish the value of the decedent's joint interest.

As with any other schedule, the valuation of any Schedule E property should be properly substantiated with statements or appraisals where applicable.

G. Schedule F- Other Miscellaneous Property

In the author's opinion, Schedule F is the schedule which presents the practitioner with the most potential problems and/or difficulties. Most of the assets reported in Schedules A through E are easily identified and a supportable valuation is readily available. However, Schedule F is the "catch all" schedule so to speak, in that all other assets are to be reported. For example, the assets properly reported on Schedule F include (but are not limited to):

- debts due the decedent (other than note or mortgages described on Schedule C;
- business interests;
- insurance on the life of others;
- artwork;
- collectibles;
- rights;
- royalties;
- leaseholds;
- judgments;
- revisionary or remainder interests;
- shares in trust funds;
- household goods and personal effects;
- farm products and crops;
- livestock; farm machinery,
- automobiles and other vehicles,
- stock options;
- patents;
- licenses;
- franchise interests;
- copyrights;
- trademarks;

- retained royalty interests; and
- qualified terminable interest property (“QTIP”) property (on the surviving spouse’s Form 706).

The valuation of these assets often require an appraisal, and finding someone who is qualified to value certain items might be easier said than done.

H. Schedule G- Transfers during Decedent’s Life

Any items that the decedent transferred for less than adequate and full consideration during his or her lifetime are properly reported on Schedule G. Specifically, these transfers include:

- Certain transfers made within 3 years of the decedent’s death (i.e., those covered by IRC § 2035);
- Transfers with retained life estates (i.e., those covered by IRC § 2036);
- Transfers not effective until the decedent’s death (i.e., those covered by IRC § 2037); and
- Transfers which were revocable during the decedent’s lifetime (i.e., those covered by IRC § 2035).

Note: any affirmative answers to Questions 11 and 12 on Part 4 will require the completion of Schedule G.

Potential §2035 property which would be reported on Schedule G would include the following:

- Gift taxes paid by the decedent (or his estate) on gifts made within three years of the date of death §2035(c)); and/or
- Transfers of life insurance policies (on the decedent’s life or on the lives of others) within three years of the decedent’s death (§2035(a));

§2036 Property would include the decedent’s interest in a Grantor Retained Annuity Trust (commonly referred to as a “GRAT”) and/or a Qualified Personal Residence Trust (“QPRT”) if the decedent passes away during the trust term. Both are very common estate planning techniques which should not be overlooked in completing Schedule G.

IRC §2037 covers any property transferred by the decedent during his lifetime, but conditioned on the recipient’s survival.

The most common type of §2038 property is property transferred to a revocable trust during his lifetime. Thus, in situations where the decedent had a pourover will and living trust estate plan, all of the decedent’s interest in the trust assets would be properly reported on Schedule G. As most practitioners know, for such an estate plan to be effective for purposes of avoiding probate in some or all jurisdictions or for continuity of management purposes, the decedent’s property must be transferred and/or titled in the name of the trust. When this has been done correctly, some (or even all) of the decedent’s property which would otherwise be included on another schedule will instead be reported on Schedule G.

I. Schedule H- Powers of Appointment

In reviewing the decedent’s gross estate, the preparer must determine whether the decedent held any general powers of appointment at the time of his or her death (or whether he/she exercised or released any such powers during his or her lifetime). If so, these powers must be reported on Schedule H. While most practitioners are careful to clearly delineate between limited and general powers of appointment, and ensure that ascertainable standards are used in their estate planning documents, the distinction might not be so clear cut in some older wills or trust agreements.

In reporting any powers of appointment (or in attesting that a power of appointment is not includible in the decedent’s estate), a verified copy of the applicable will or trust instrument must be attached to the Form 706.

J. Schedule I- Annuities

All interests in annuities owned by the decedent are properly reported on Schedule I. Under Section 2039, an annuity is: “a contract or agreement (other than as insurance under policies on the life of the decedent) if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death for any period which does not in fact, end before his death”. In most cases, the preparer will be dealing with commercial annuities, which are readily identifiable and valued in accordance with Treas. Regs. 20.2031-8 (a). More often than not, the commercial annuity will be valued by the issuing company, which will issue a Form 712 to the executor.

A private annuity (or “PA”), however, is much more complicated and likely to invite additional IRS scrutiny. In a PA transaction, an individual (a family member in failing health) sells an asset to family members (or to a trust for the benefit of family members) in exchange for an unsecured promise to pay the selling family member an annuity for life based upon the standard mortality tables and the IRC §7520 rate. The asset sold is subsequently removed from the seller’s gross estate for federal estate tax purposes, and the annuity payments are to cease upon the seller’s death.

In valuing the private annuity, the standard actuarial tables (including the mortality component), may be used unless an individual is "terminally ill," in which case the valuation must be based upon the individual's actual life expectancy. Treas. Reg. §25.7520-3(b)(3).

To be considered "terminally ill", the individual must have an incurable illness or other deteriorating physical condition such that there is at least a 50% probability that the individual will die within one year. If the individual survives for at least 18 months after a transfer, such individual is presumed not to have been terminally ill at the time of making the transfer unless the IRS can rebut the presumption by presenting "clear and convincing" proof to the contrary.

Obviously, the evidence regarding the likelihood of the individual has more or less than a 50% chance of survival should come from qualified medical professionals who are familiar with the individual's condition and who are comfortable with the concept of statistical prognosis. Though not required, if possible such evidence should be reduced to writing on or near the date of the transfer.

Based on these time sensitive requirements, it is imperative that the implementation of techniques that are based upon the actuarial tables occur as soon a possible after an individual is diagnosed. This puts the planner in the delicate position of raising these potential estate planning "opportunities" at a very emotional and trying time for the client and his or her family.

Since only the payments actually received are included in the seller's gross estate, the gross estate is reduced to the extent he or she receives fewer annuity payments than contemplated under the standard mortality tables, and is increased to the extent he or she receives more annuity payments than contemplated under the standard mortality tables. Accordingly, the asset that is exchanged for a PA must appreciate in an amount in excess of the §7520 rate, or the seller must die prematurely for the technique to achieve the maximum estate tax benefits from the transaction. If the decedent sold assets in return for a PA, the preparer should inquire about the transaction, and review all relevant documentation regarding the transaction, including the decedent's medical records.

K. Schedule J- Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims

Schedule J covers certain funeral and administrative expenses which are deductible under IRC § 2053. The most common of such expenses are:

- Funeral expenses;
- Executor's commissions;
- Trustee's commissions and fees; and
- Attorney's fees.

For a funeral expense to be deductible, the Regulations provide that they must be (i) actually expended and (ii) permissible under local law. Treas. Regs.20.2053-2. Thus, while tombstones and burial plots may be deductible, costs related to meals, memorial services and receptions are often disallowed by the IRS.

Executors fees must be in accordance with "usually accepted standards and practice in estates of similar size and character" and permissible under local law. Treas. Regs. §20.2053-3(b).

Similarly, the Regulations provide that attorney's fees must be related to the administration of the estate, and "reasonable" based on the service provided, nature of the estate, jurisdiction and attorney's experience. Treas. Regs. §20.2053-3(c).

Note: The Form 706 Instructions provide that when the values claimed for executor's fees and commissions and attorney's fees are estimated (and have not been paid at the time of filing), the executor should submit affidavits stating that the amounts have not been paid but have been agreed upon by the beneficiaries.

In addition the aforementioned fees, other administrative expenses are also properly deducted on the 706, including court fees, legal notices, publications, preservation of estate assets, and the expenses associated with selling assets (provided that the sale is needed to pay taxes or other estate expenses.) In determining the reasonableness of the deduction of any miscellaneous expenses, the primary question should be whether the expense is necessary to the estate administration process (rather than is it a benefit to the beneficiaries). Thus, in certain circumstances, appraisal fees (which are often substantial) would be properly deducted. Treas. Regs. 20.2053-3)(d)(1).

In addition, expenses necessary to preserve and maintain real property such are also generally deductable. These might include property insurance, home association dues, security fees, utilities, etc. depending on the particular circumstances. (Treas. Regs. 20.2053-3(d)(1)).

Note: In determining which expenses to take on the 706, the preparer should consult the estate's accountant responsible for preparing the estate's 1041. While a decedent's funeral expenses are only deductible on the 706, virtually all other administrative expenses may be taken on either the Form 706 or the Estate's Form 1041. However, great care must be taken to avoid any double-deductions, and if the deductions are taken on the Form 1041, the estate must file a waiver (waiving its right to claim the deductions on the Form 706) under IRC §642(g).

L. Schedule K- Debts of the Decedent and Mortgages and Liens

In addition to the administrative expenses described above, the decedent's debts are also deductible from the decedent's gross estate and are properly reported on Schedule K. The most common debts (which are often overlooked on the Form 706) are mortgages taken by the decedent and his or her unpaid taxes, which have accrued before the decedent's date of death. Because the regulations require claims to be legally valid in order to qualify for the deduction, it is often preferable to have a formal court claim from a creditor to ensure its deductibility.

The decedent's medical expenses are deductible on the Form 706 on Schedule K (or instead, may be taken on the decedent's final income tax return if (i) paid within one year of death and (ii) if they exceeded 7.5% of the decedent's adjusted gross income for such period.

M. Schedule L- Net Losses during Administration and Expenses Incurred in Administering Property Not Subject to Claims

Casualty losses to estate property occurring during the administration of the estate are properly deducted on Schedule L. Such losses would include theft, storms, fires, shipwrecks, etc. Treas. Reg. §20.2054-1. The amount of the deduction must be reduced by any insurance reimbursements, and the losses claimed must be described in detail.

In addition, any expenses related to the administration of non-probate property included in the gross estate are also reported (and deducted on Schedule L). For example, these might include expenses related to the administration and winding down of any revocable trusts created by the decedent or a QTIP marital deduction trust of which the decedent was a beneficiary (which would be includible in his or her gross estate).

N. Schedule M- Bequests, etc. to Surviving Spouse (Marital Deduction)

Most estate planning practitioners are well aware of the marital deduction from estate and gift taxes found in Section 2056. Put simply, the marital deduction applies to any property transferred from the decedent to a surviving, U.S. citizen spouse. However, the deduction only applies when the interest is sure to be included in the surviving spouse's estate upon his or her death (i.e., an outright bequest or gift to a qualified terminable interest property such as a "QTIP" trust). Treas. Regs. 20.2056(a).

In most cases, there is not a concern about a retained interest in the property by the deceased spouse. For purposes of preparing the Form 706, the preparer generally deals with outright bequests to the surviving spouse and/or bequests to a qualified terminable interest "QTIP" trust. Under Section 2056(b)(7), in a trust must meet the following conditions in order to qualify for QTIP treatment, the beneficiary of the trust must be entitled to receive all of the trust income at least annually during his or her lifetime, and no person may direct any portion of the trust property to anyone other than the surviving spouse. IRC § 2056(b)(7)(B)(ii).

The executor of the predeceased spouse must elect QTIP treatment for the property in question by listing the asset(s) on Section A of Schedule M on the 706.

The Regulations under §§20.2056(b) provide the executor with a great deal of flexibility in making the election in that partial elections are permitted in certain circumstance (i.e., when the election involves a fractional share).

Because the funding of marital deduction amounts are often based upon a formula, (i.e., the gift of the applicable exclusion amount to a credit shelter or bypass trust with the residue passing to the spouse outright and/or to a QTIP trust), the executor is required to attach an explanation of the calculation of the marital share. This explanation should carve out and/or describe the assets (or values of assets) passing to non-spouse beneficiaries (i.e., non marital deduction property) as well as the assets listed on Schedule M for which the executor is claiming a deduction.

Note: In completing the "Exhibit M-1" explanatory attachment for Schedule M, it is advisable to provide for any adjustments to the value of these assets after the filing of the return (i.e., upon audit). For example, language along the lines of the following statement should be added to make a "protective" election for these assets:

> "In determining the marital deduction for the estate, the value of the property as finally determined for federal estate or gift tax purposes (reflecting any adjustments on examination or audit) should be used, it being the executor's intention to claim the Decedent's maximum marital deduction (allowable under Section 2056 of the Code in determining the Federal estate tax in the Decedent's gross estate)".

O. Schedule O- Charitable, Public and Similar Gifts and Bequests

Any property transferred by the decedent during his or her lifetime, or at death by will, to a qualified charitable organization described in IRC §2055 is property reported and deducted on Schedule O. §2055 organizations include:

- Governmental organizations for public purposes;
- Charitable organizations (to be used for exclusively religious, charitable, scientific, literary or educational purposes;
- Non-charitable organizations with charitable purposes;
- Veterans' organizations; foreign governments for charitable purposes.

The §2055 deduction is limited to any amounts actually used and/or available for charitable or public use.

P. Schedule P- Credit for Foreign Death Taxes

Any estate, inheritance, legacy or succession taxes payable to a foreign country for property located in such country (and not included in the gross estate) are properly reported on Schedule P, and a credit is allowed under §2014(a).

If such taxes are paid to multiple countries, a separate Schedule P must be completed for each such jurisdiction.

Q. Schedule Q- Credit for Tax on Prior Transfers

Under §2013, a credit is allowed against a decedent's federal estate tax liability with respect to property which the decedent (the "transferee") received from another person (the "transferor") who died within the 10 years preceding OR two years after the decedent's death. In such cases, a credit is allowable (on the transferee's Form 706) for all (or a part) of the estate taxes paid by the transferor's estate related to the transfer.

The property need not be identified in the transferee's estate for the credit to apply. So long as the property in question was subject to estate taxes within the applicable time period, the credit should be allowed.

Note: This credit does not apply if the transferee was the decedent's surviving spouse, and the property qualified for the marital deduction. Further, the credit does not apply to prior transfers on which gift taxes were paid.

R. Schedules R & R-1: Generation-Skipping Transfer Tax

Schedule R can be a source of angst for the preparer, and in the author's opinion, is the schedule that is often overlooked or completed incorrectly by practitioners. In short, the Schedule R and R-1 are used to calculate the amount of generation-skipping transfer ("GST") tax due as a result of certain direct skips upon the decedent's death. A detailed discussion of the GST tax is beyond the scope of this presentation; however, I have provided a brief explanation in this Section R.

The generation-skipping transfer tax is a transfer tax (which is separate from, and in addition to, estate or gift taxes) imposed on transfers that, as the name suggests, "skip" a generation. For example, a testamentary bequest from a grandparent to a grandchild would be subject to the tax, as would certain transfers or distributions to a grandchild from a trust created by a grandparent. The GSTT is a flat tax equal to the highest federal estate tax rate in effect at the time of the transfer (40% in 2014). (IRC § 2631(a)(1)).

As with the estate and gift taxes, each person has an exemption amount from the GSTT, which is currently $5,340,000 and coincides with those for the gift and estate taxes. IRC §2631(c). Importantly, while the decedent's estate tax exemption is subject to the portability provisions discussed above, the decedent's GST exemption is not.

From the preparer's standpoint, the most common purpose of completing the Schedule R is to allocate the decedent's remaining GST exemption amount to the beneficiaries (and crucially, to trusts created upon the decedent's death).

Schedule R, Part 1 contains the GST Exemption Reconciliation provisions, and is where the executor can allocate the decedent's GST exemption to certain transfers. If Schedule R is not completed, then the automatic allocation rues of IRC § 2632(e) will apply. This is not ideal in that the Regulations under Section 2632 provide that the unallocated exemption will be split and allocated equally to all trusts to which the decedent transferred property (and from which a taxable distribution or termination is possible). This likely results in the aforementioned trusts having inclusion ratios of greater than zero but less than one, which is not optimal. Thus, instead of having certain trusts fully exempt from the GST (preferably those in which taxable distributions are likely), the end result is multiple trusts which are partially subject to the GST. Treas. Regs. 26.2632-1(d)(2).

The executor allocates the decedent's GST exemption to trust on Line 9, which requests the name of the trust and its tax identification number, the amount of exemption allocated and the inclusion ratio of the trust.

S. Schedule U- Qualified Conservation Easement Exclusion

IRC §2031(c) provides for the exclusion from the gross estate for certain real property subject to a conservation easement. Importantly, the easement does not have to be in effect at the decedent's death, and if the property meets the requisites, may the conservation may be set up by the estate (or the decedent's heirs on or before the due date for the Form 706.

To qualify, the property must be located within the United States (or a U.S. Territory) and have been owned by the decedent (or his family) for the three year period leading up to the decedent's date of death. Up to 40% of the value of the qualifying land may be excluded for estate tax purposes.

By filing a Schedule U, the executor makes the §2031 election. The value of the land will likely be best determined by appraisal, as the executor will need to determine and substantiate the appropriate value for the conservation easement (reported on Schedule U and/or O, as appropriate) and the value of the real property on Schedule A, B, E, F, G, or H, as the case may be.

T. Schedule PC- Protective Claim for Refund

Schedule PC may be completed to preserve the estate's right to a refund for taxes paid on any amount included in the gross estate which would have been deductible under IRC § 2053, but has not been paid or otherwise realized. The description on the Schedule PC must clearly identify the outstanding claim or expense that is a potential deduction, in addition to an explanation of the reasons and contingencies delaying the actual payment of the claim or expense. A separate Schedule PC for each claim or expense must be completed. Further, two copies of each Schedule PC must be included with the Form 706 as filed.

V. CONCLUSION

On one hand, the recent fluctuations in the estate tax laws (and particularly in the applicable exemption amount) have reduced the number of clients for whom an estate tax return is required. However, the advent of portability has, in a sense, offset that reduction, as we may now find ourselves filing estate tax returns for decedents with non-taxable estates solely for the purposes of preserving his or her DSUE for the surviving spouse. As such, the Form 706 is something with which all practitioners in the estate planning area must be familiar. Whether the practitioner is involved in the preparation and filing of these returns or not, their familiarity with them is nothing but beneficial as they counsel their clients, draft documents and craft estate plans on their behalf.