# Form 706
# A Detailed Look at the Schedules



## Summary

While its daunting title “United States Estate (and Generation-Skipping Transfer) Tax Return” may serve to overwhelm even the most seasoned professional all on its own, Form 706 schedules further serve to confuse and overwhelm. This course will help the practitioner to put assets, liabilities, trust holdings, and community property allocations where they belong and will provide sample entries to mitigate—and possibly eliminate—IRS scrutiny of the completed return.

***The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.***



## Instructor

Monica Haven, E.A., J.D. will happily address follow-up questions. You may contact her at:

(310) 286-9161 PHONE
(310) 557-1626 FAX
mhaven@pobox.com
www.mhaven.net

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## I. Introduction

By definition, the whole of property owned by anyone, including both real and personal property, is deemed to be that person's estate.[1] Upon death, this estate will be distributed in accordance with the terms of the decedent's will (trust) or, if there is no will, by the laws of intestacy applicable in the state of the decedent's domicile.

Depending on the size of the decedent's estate, **Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return** [Form 706] may be required.[2] Although a return is in fact only required if the decedent's estate (valued on the date of death [DOD]) plus taxable lifetime gifts exceeds the applicable exclusion amount for the year of death, the fiduciary may nevertheless opt to file to:

- Obtain a closing letter[3] from the IRS, thereby putting all estate tax matters permanently to rest; or
- Establish cost basis for the surviving heirs, stepped-up to the DOD valuations as reported on the return; or
- Lock in the estate tax exclusion established under spousal portability; or
- Preclude claims by disgruntled heirs based on accepted asset valuations.

In this text, I will begin by taking a look at the filing requirements in general and then proceed to examine the schedules and components of the estate tax return in detail. I will attempt to explain the rationale and legislative intent of applicable code sections and provide preparer tips to ensure that the return you ultimately file can survive IRS scrutiny.

## II. Form 706

### A. Due Date and Extension

**Form 706** is due nine months after the DOD[4] or April 15th of the calendar year following the date of distribution from a Qualified Domestic Trust.[5]



[1] IRC § 2033.

[2] The estate tax is an asset-based tax, not an income tax.

[3] While closing letters were previously issued by the IRS in most situations, they are issued only *upon taxpayer request* for estate tax returns filed on or after June 30, 2015. Such requests may be made by calling the IRS at (866) 699-4083 no sooner than four months after filing **Form 706**. As per IRS Notice 2017-12, fiduciaries may use **Form 4506-T, Request for Transcript of Tax Return** to obtain an account transcript in lieu of a closing letter. Since the transcript will indicate transaction code "421" accompanied by the explanation "closed examination of tax return", it serves as the functional equivalent of the closing letter. NOTE: The IRS may re-open a confirmed closed case if (1) there is evidence of fraud or misrepresentation of material fact; (2) the closed case involved a clearly-defined, substantial error, or (3) other circumstances indicating that a failure to reopen a case would be a serious administrative omission. Additionally, the IRS may reopen a case to determine the estate tax liability of a surviving spouse who uses the decedent spouse's unused exclusion.

[4] IRC § 6075(a).

[5] IRC § 2056A(b)(5).

**Qualified Domestic Trust (QDOT)**

U.S. tax law imposes restrictions on transfers to non-U.S. citizens for fear of losing jurisdiction and the ability to tax dollars that have left the country. As a result, the marital deduction for the transfer of property directly to a non-citizen spouse is disallowed[6] but permitted if the estate of a citizen spouse is transferred to the non-citizen spouse in trust[7] under the following conditions:

- All trustees must be individual U.S. citizens or, if trust assets exceed $2 million, the trustee must be a domestic bank;
- The surviving spouse must receive all of the trust's income, paid at least annually;
- The trust must pay the requisite tax on any income other than what is distributed annually to the surviving spouse as well as the tax due upon the death of the surviving spouse; and
- An irrevocable election to treat the trust as a QDOT must be made on the decedent's estate tax return.

Separate returns are required for husband and wife even if death occurs (near-) simultaneously in the same calendar year, since **Form 706** may be used to report the estate of only one decedent and each spouse has his own lifetime exclusion.

**Form 4768 Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes** may be used to automatically extend the filing (but not payment)[8] deadline by six months.

No estimated tax is due; the tax liability must be paid in full with the filing of the return or the extension request. However, extensions for payments are available:

- For up to ten years for reasonable cause,[9] although interest on the unpaid balance will continue to accrue[10]
- For up to five years if more than 35% of the decedent's wealth is tied up in a closely-held business or farm[11] – the tax must then be paid in ten equal annual installments.

NOTE: Interest accrued on an estate tax liability deferred for hardship reasons is deemed to be personal interest not deductible on the fiduciary income tax return,[12] although it may be claimed on the estate tax return as an administration expense [on *Schedule L*].

### B. Liability for the Tax

The personal representative of the decedent's estate is personally liable for the estate tax due, as well as any unpaid income, gift and generation-skipping taxes. He may request release from personal liability from the estate tax as early as nine months after the estate tax return is due (or filed, if later) by submitting a written application to the IRS and paying all



[6] IRC § 2056(d)(1).

[7] IRC § 2056(d)(2).

[8] Reg. 20.6151-1.

[9] IRC § 6161(a)(2).

[10] A Late Filing Penalty of 5% of tax per month (up to 25%) may be assessed in addition to a Late Payment Penalty, as well as interest on any unpaid balance due.

[11] IRC § 6166. Executor's request to pay tax liability in installments was denied when it did not conform to the specific requirements of the election and the return was not timely filed (*Estate of Woodbury v Comm.*, TCM 2014-66).

[12] IRS Chief Council Advice 200836027.

outstanding balances or posting a bond if the payment period was extended.[13] He may also file **Form 5495 Request for Discharge from Personal Liability under Internal Revenue Code Section 2204 or 6905** to request early discharge from personal liability for a decedent's income and gift taxes.[14]

In certain circumstances, a decedent's heir may become liable for the unpaid taxes of a decedent under the principle of transferee liability.[15]

## C. Statute of Limitations

As with all returns, the IRS has three years in which to audit an estate tax return;[16] however, the estate's representative may file **Form 4810 Request for Prompt Assessment under Internal Revenue Code Section 6501(d)** to shorten the statute of limitations to eighteen months. Instructions for the form specifically state that it may not be filed until all returns listed on the request have already been filed. The practitioner should advise the fiduciary that this request will almost assuredly invite scrutiny of the tax return by IRS examiners and so the request should be made only upon due consideration.

## D. Penalties

Taxpayers may be subject to penalties ranging from late filing and late payment assessments[17] to penalties arising from valuation misstatements for which they will be assessed 20% of any underpayment caused by a substantial over- or understatement of value.[18]

Persons – including lawyers, appraisers, and tax practitioners – who knowingly aid and abet the understatement of another's tax liability may also be penalized.[19] In 2007, preparer penalties for understatement of a taxpayer's income tax liability were extended to include preparers of estate and gift tax returns.[20]



[13] IRC § 2204.

[14] IRC § 6905(a).

[15] IRC § 6901(c)(1). Where executors distributed the balance of an estate to themselves as beneficiaries, leaving the estate insolvent to pay its tax liability, the Court held the family fiduciaries personally liable (*US v Shriner*, March 12, 2014, US District Court, D. Maryland).

[16] The three-year statute of limitations may be extended to six years for substantial understatement of value on an estate tax return [IRC § 6501(e)(2)]. For returns filed after July 31, 2015, the six-year period may be also triggered by the over-statement of unrecovered cost or basis [Surface Transportation and Veterans Health Care Choice Improvement Act of 2015].

[17] IRC §§ 6651(a)(1) and (2).

[18] IRC § 6662 defines "substantial" misstatements as those that are 65% or less of the determined value and cause a tax understatement of more than $5,000. The penalty is increased to 40% for "gross" valuation misstatements which are 40% or less of the determined value.

[19] IRC § 6701.

[20] IRC § 6694.

**ESTATE TAX**

- ***Form 706* is due nine months after DOD but the filing deadline can be extended an additional six months with *Form 4768*.**
- **The tax liability must generally be paid nine months after DOD.**
- **The personal representative of the estate may apply to be released from personal liability for the estate, gift and income taxes of the decedent.**
- **The IRS may audit an estate tax return for up to three years after filing, but the statute may be shortened to 18 months by filing *Form 4810*.**
- **Various penalties may be assessed against both the personal representative and the preparer of the return.**

## III. The Gross Estate[21]

A decedent's gross estate includes his worldly possessions; in other words, the total of all of his property owned—wherever situated—on the DOD. This includes (a) cash, investments, retirement assets, tax-exempt assets, business assets, real and personal property; (b) probate, as well as jointly-held assets; (c) non-taxable assets exempt from taxation under the marital or charitable deductions; (d) life insurance and annuities, as well as special interests and powers;[22] and (e) one-half of the decedent's community property.

Under certain circumstances, additional assets may be added back to the gross estate that had been previously transferred and would appear to no longer have been in the decedent's possession on the DOD. When an individual retains the right to revoke a transfer to a trust until his death, or disposes of that right within three years of death, the trust assets in that trust will be includible in his gross estate [*Schedule G*].[23] On the other hand, gifts from a grantor trust will be treated as though they were made by the decedent himself; as a result, they are eligible for the annual gift tax exclusion and not includible in the estate.[24]

### The Estate Tax Calculation

The estate tax liability is computed based on the Gross Estate [GE] less applicable Deductions [D][25] which results in the Taxable Estate [TE]. The Tax Base [TB], then, requires that Adjustable Taxable Gifts [ATG] are added back to the Taxable Estate.[26]

In short, the formulas used to calculate the estate tax liability is:

**TE = GE – D**

**TB = TE + ATG**

[21] Computed on **Form 706**, Page 3, Line 10 and carried to Page 1, Line 1 for tax computation.

[22] IRC § 2505.

[23] IRC § 2038.

[24] IRC § 2035(e).

[25] IRC § 2051.

[26] IRC § 2001(b)(1).

## Deductions

**State Death Taxes** – prior to 2005, federal law allowed for a credit against the federal liability for estate taxes paid to state taxing authorities, but the credit was replaced with a deduction [***Form 706****, Page 1, Line 3b*].[27] States that previously calculated their tax liability by charging an amount equal to the maximum federal credit (now no longer inexistence) were required to change their tax structure or lose estate tax revenues.[28]

**Other Expenses** – to be deductible, expenses must be reasonable and necessary both under federal and state law.[29] For example, the interest expense incurred by a trustee to maintain, rather than sell a trust asset for seven years was disallowed because the expenditure was incurred for the benefit of the heirs and not the estate.[30]

Commissions and fees may be deducted if actually paid or reasonably estimated. The expense of selling estate assets is deductible if it is necessary to pay the estate's obligations. The cost of recourse debt is deductible. On the other hand, assets secured by *non*-recourse debt are reported on **Form 706** net of the liability; therefore, the associated mortgage is not deductible. Deductions may be taken for services (i.e. caretaking) provided to the decedent at the full value of the consideration bargained for—even if that amount exceeds what would otherwise be considered fair market value [FMV].

## Tax Rate

The maximum effective rate in 2017 is 40%.[31]

## Applicable Exclusion (Unified Credit)

Once the tax rate is applied to the tax base and the tentative tax liability is calculated, an exclusion may be applied to reduce the tax liability ultimately due. The applicable gift and estate tax exclusion amount in 2011 was $5 million ($10 million for husband and wife). Indexed for inflation after 2011, the exclusion currently in 2017 is $5.49 million per individual.[32]

The lifetime exclusion is applicable to both gift and estate taxes and, in fact, has been unified under the Tax Reform Act of 1976 and renamed the "Applicable Credit Amount". While the effect is the same, the exclusion is used to reduce the amount of taxable estate; whereas the credit is used to reduce the amount of tax due. Therefore, when properly computing the estate tax liability on **Form 706**, the taxpayer begins by calculating the tax on the *full* value of the taxable estate. Only after the tax is calculated, may the taxpayer then subtract the applicable credit to determine the actual tax due.



[27] IRC § 2058.

[28] A detailed and updated listing of applicable state laws is available at http://www.jdsupra.com/legalnews/mcguirewoods-llp-state-death-tax-chart-44155/ [last accessed May 29, 2017].

[29] Reg. § 20.2053-3a.

[30] *Hibernia Bank*, 581 F2d 741 (1978).

[31] IRC § 2001(c) provides the current graduated rate schedule.

[32] This exclusion translates to an estate tax credit of $2,141,800 (based on current applicable tax rates).

## **Portability**

Effective January 1, 2011, the exclusion for married couples has been treated as a collective exemption which means that any portion of the exclusion which was not used by the first spouse to die becomes portable and transfers to the surviving spouse.[33] The DSUE may even transfer to a surviving spouse who becomes a US citizen after the deceased spouse's death.[34]

> *In the old days… Husband (H) and Wife (W) had $6 million in total assets when H died in 2008. W inherited all of H's assets free of tax due to the unlimited marital deduction; thereby "wasting" H's estate tax exclusion. When W died in 2009, only a portion of her $6 million estate was shielded from tax by her then-applicable estate tax exclusion of $3.5 million; the remaining $2.5 million was subject to estate tax at the then-applicable rate of 45%.*
>
> *Under current law… If H had instead died in 2012, the executor of his estate could have used the unlimited marital deduction to transfer all assets to W and also made an election to transfer H's DSUE to W for future use. If W would then have died in 2014, her estate would be entitled to an exclusion of $10.46 million (= $5.12 million of H's exclusion + $5.34 million of W's exclusion based on allowable amounts in each respective year of death). As a result, none of the $6 million estate would be subject to estate tax.*

To ensure portability of the Deceased Spouse's Unused Exemption (DSUE), **Form 706** must be timely filed.[35] While the executor of deceased spouse was previously required to make an affirmative election to transfer the unused exemption to the surviving spouse, final regulations issued by the IRS merely require that the estate tax return is complete and properly prepared with a DSUE amount of zero[36] and that no affirmative election *out* of portability is made.[37]

If the decedent's estate is below the filing threshold and an estate tax return would otherwise not be required, Form 706 must nevertheless be submitted if only to establish the portability of the DSUE. Final regulations[38] issued by the IRS provide the following specific guidelines for the preparation of **Form 706** prepared solely for DSUE purposes:

- The decedent's assets should be listed on each appropriate schedule (as is customary) but corresponding values should not be entered. Instead, the total value of the decedent's estate should be estimated using the IRS' Table of Estimated Values available in the **Form 706** Instructions and that total should be entered in the Recapitulation section Part 5, Line 10.
- Joint interests held by the decedent and spouse which would normally be listed at full value on each appropriate schedule subject to a deduction for the value attributable to the joint owner; should instead be estimated and entered in the Recapitulation section Part 5, Line 23.
- Therefore, only Lines 10, 13, 23 and 24 of Part 5 would be completed for the DSUE filing before returning to Part 2 of **Form 706**.



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[33] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, § 303(a); provisions were made permanent by the American Taxpayer Relief Act of 2012.

[34] Treas. Reg. §20.2010-3(c)(2).

[35] IRC § 2010(c)(5)(A).

[36] Entered on Page 4, Part 6, Section C, Line 10 of **Form 706.**

[37] Treas. Reg. §20.2010-2(b).

[38] Internal Revenue Bulletin 2015-26.

- Lastly, Part 6 of **Form 706** must be used to compute the amount of DSUE that will be ported to the surviving spouse. NOTE: Portability is automatic; the preparer must affirmatively check the box in Part A to elect *out* of portability.

Portability applies only to a surviving spouse and cannot be transferred to any other beneficiary. Unlike assets placed into an exemption trust ("B-Trust") upon the death of the first spouse to die, DSUE portability ensures that only a fixed portion of the surviving spouse's assets will be shielded from future taxation since the transferred exemption is set at the time of the decedent spouse's death and not indexed for inflation or adjusted for asset growth in the period between the first and second spouse's passing.

The surviving spouse's new lifetime exclusion amount is the total of (1) the survivor's exclusion amount determined by the applicable exemption in the year of death plus (2) the ported DSUE amount from the decedent spouse. The sum of these amounts is called the survivor's "applicable exclusion amount".

If, however, the surviving spouse were to remarry, the DSUE inherited from the original spouse would be eliminated and the surviving spouse would instead be entitled only to the DSUE of the newest (latest) pre-deceased spouse whether or not the estate of the last deceased spouse filed an election to port the decedent's DSUE to the surviving spouse or the last deceased spouse even had an unused spousal exclusion amount.

NOTE: Portability does not apply to the Generation-skipping Tax (GST) exemption; therefore any unused portion of the exemption [$5.49 million in 2017] is not transferrable to a surviving spouse.

**<u>Sample Calculation</u>**[39]

Decedent made $1.5M taxable gifts between 2002 and 2005. His gross estate was valued at $6 million when he died in early 2011 and he had no allowable deductions.

| | |
|---:|---|
| $555,800 | Gift tax liability on previously-made $1.5 million taxable gifts |
| <u>– 345,800</u> | Lifetime credit allowed on $1 million of gifts (based on credit available during tax years 2002 – 2005) |
| $210,000 | Gift tax previously paid during lifetime |
| | |
| $6M | Gross Estate |
| <u>$0</u> | Deductions |
| $6M | Taxable Estate |
| <u>+ 1.5M</u> | Previously-made taxable gifts |
| $7.5M | Tax Base |
| | |
| $2,605,800 | Tentative estate tax liability |
| <u>– 1,730,800</u> | Applicable Credit (based on $5M in 2011) |
| $875,000 | Tentative Tax |
| <u>$210,000</u> | Gift tax previously paid [see above] |
| $665,000 | Estate tax due |



[39] Computed on **Form 706**, Page 1, Lines 1 – 20.

| THE GROSS ESTATE |
|---|
| • **The estate tax is assessed against the gross estate net of allowable deductions.**<br>• **Gifts made by the decedent during life are added back to the taxable estate; a credit for previously-paid gift taxes may be applied against the resulting estate tax.**<br>• **The maximum tax rate (in 2017) is 40%.**<br>• **Each decedent is entitled to a Unified Credit ($2,141,800 in 2017) which, if not previously reduced or used in its entirety by lifetime gifts, may now be used to reduce the computed estate tax liability.**<br>• **The portion of the exclusion which was not used by the first spouse to die becomes portable and automatically transfers to the surviving spouse if *Form 706* is timely filed.** |

## IV. Estate Assets

Information entered and totaled on each separate schedule of **Form 706** is carried over to Page 3, Part 5 and summarized there. Two columns provide for the opportunity to list values of the decedent's assets on the DOD as well as on the Alternate Valuation Date [AVD].

### A. Alternate Valuation Date

The general rule for **Form 706** reporting requires the decedent's property to be valued on the DOD,[40] but the estate's representative may instead make an irrevocable election to report values on the AVD, up to six months later.[41] If an asset was disposed of or transferred to the estate's beneficiary prior to the six-month valuation date, AVD valuation of that asset is determined on the date of disposition or transfer.

The AVD may only be used if it serves to *decrease* the value of the gross estate, as well as the attendant Estate and Generation-Skipping Tax liability.[42] If **Form 706** is not filed or no estate tax is due, the AVD may not be elected. Nor may the AVD be used to step-up the basis of assets that have increased in value since DOD.

*Husband passes away and leaves all assets to his wife. The AVD may not be used since the unlimited marital deduction would eliminate any estate tax due.*

If the AVD is elected, the following guidelines must be followed:

- The value on the date of disposition (transaction) must be used for all assets sold, exchanged or otherwise disposed[43] of within six months after the DOD.
- All other assets are valued at FMV on the AVD, except those affected by the mere lapse of time, such as remainder and reversionary interests which are valued at DOD.
- Interest earned after death but before the subsequent valuation date does not need to be included on **Form 706** when the AVD is elected.[44]

[40] IRC § 2031.

[41] The election is made for the estate as a whole and not on an asset-by-asset basis and is indicated by checking "Yes" on **Form 706**, Part 3, Line 1.

[42] Reg. § 20.2032-1(b)(1).

[43] "Disposition" does not include the transfer of title from the decedent to his surviving spouse or beneficiary.

[44] Treas. Reg. § 20.2032-1(d).

## B. Exempt Assets

While property in which the decedent held an interest at the time of his death is includible in the estate,[45] certain assets are not part of a decedent's gross estate if, for example, there is a mere expectancy of receipt but no guarantee of payment. In the case in which a company paid a discretionary wage dividend to a deceased employee's widow, the Court held that this dividend was not includible as an estate asset since the decedent did not have any vested rights at the time of his death and could not have enforced or demanded payment.[46]

Similarly, wrongful death recoveries, Social Security, certain Veterans' Administration (VA) survivor benefits[47], certain railroad retirement benefits, and workman's compensation are excluded.

> *Bob was hit by a drunk driver and incurred significant medical expenses before succumbing to his injuries. His family sued the driver for wrongful death and obtained a large judgment. Bob's medical expenses are deductible by the estate because they accrued prior to death but the wrongful death damages are not includible as an estate asset because the decedent did not have any rights to them prior to or on the DOD.*

## C. Income in Respect of Decedent [IRD]

Cash-basis taxpayers report only that income on their tax returns which they have actually received. Therefore, if a decedent dies after he earned the income but before it was paid to him, he will not have had reportable income on his personal tax return. Instead, the income—now known as IRD—is taxed either to the estate or to the heir depending to whom this income is actually paid.[48]

Examples of IRD include, but are not limited to:

- Proceeds from the sale of a jointly-owned residence (unless the surviving tenant becomes the full owner of the property by operation of state law).
- Deferred compensation and bonuses, as well as retirement plan distributions.
- Annuity payments in excess of the decedent's investment in the contract.
- Pre-death leasehold income.

Just as there may be IRD, there may also be attendant deductions in respect of decedent [DRD] which the decedent would have had the right to deduct had he paid them prior to his death. Most deductions which could be claimed on Schedule A of **Form 1040 U.S. Individual Income Tax Return** [Form 1040] are eligible for DRD treatment, except:

- Credit card charges made by decedent, since they are considered paid when charged.
- Checks written before death if decedent had *sufficient* funds (if insufficient, then DRD).
- Decedent's medical expenses and alimony payments.

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[45] IRC § 2033.

[46] *Estate of Barr*, 40 TC 227 (1963).

[47] To be excludable, VA benefits must be payable to the survivor only and not have been available to the decedent prior to death. As per IRC § 2039, the decedent's estate does not include payments made under public laws as long as the decedent did not have the right to designate beneficiaries.

[48] IRC § 691(a).

- Depreciation is not deductible as DRD by the estate since the associated asset gets the stepped-up basis instead (but depletion expenses are deductible).
- Prior-year passive and net operating losses, as well as capital loss carry-forwards are deductible on **Form 1040** only—unused deductions are forfeited and not considered DRD.

Taxed at the time of receipt, IRD retains the same character when reported by the estate or beneficiary as it would have if it had been reported by the decedent. IRD is claimed *both* as income on the fiduciary's **Form 1041 U.S. Income Tax Return for Estates and Trusts** [Form 1041] or beneficiary's **Form 1040** *and* as an asset on **Form 706**. The estate tax attributable to the IRD inclusion on **Form 706** is deductible as an expense by the fiduciary on **Form 1041** or the beneficiary on **Form 1040**.[49] NOTE: Unlike all other assets of the decedent, IRD assets do not receive a stepped-up basis.

**<u>Estate Tax Deduction [ETD]</u>**

The ETD equals the estate tax paid on *net* IRD (after DRD has been deducted). To compute the ETD, reduce the Adjusted Gross Estate (**Form 706**, Page 1, Line 5) by the net IRD and re-compute the estate tax due. The re-computed tax is then subtracted from the actual estate tax due to determine the tax attributable to the net IRD only.[50]

The amount of ETD attributable to IRD may be allocated to the fiduciary of the estate (deductible on **Form 1041**), or the beneficiary (deductible on **Form 1040**), or ratably between both. The ETD associated with the decedent's ordinary income may be deducted as a miscellaneous itemized deduction *not* subject to the 2% AGI limitation; the ETD associated with capital gains on the estate tax return is netted against capital gain income on the fiduciary's or beneficiary's Schedule D.

NOTE: There is no ETD if: (1) **Form 706** is not required, (2) there is no **Form 706** tax liability, (3) there is no IRD on **Form 706**, or (4) DRD exceeds IRD.

### D. Valuations and Appraisals

Much hinges on the proper valuation of a decedent's property. First, the total value of the estate determines whether, in fact, an estate tax return is even due. Then, upon filing, the valuations assigned to each asset serve to determine the tax liability.

The IRS typically favors high rather than low valuations to boost tax collections. The decedent's personal representative obviously prefers the reverse, unless, of course, he is looking beyond mere estate tax consequences. Since the estate tax valuation becomes the property's new basis, future capital gains taxes would be less if property were valued high at DOD. For this purpose, the IRS would of course prefer a low valuation. Statistically, more



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[49] IRC § 691(c).

[50] The computation is tedious and time-consuming and can only be calculated by preparing **Form 706** *twice*; once with the net IRD included and then again without net IRD included in the taxable estate. The difference between the resulting tax liabilities represents the estate tax attributable solely to the net IRD; it is this amount that may be claimed as an income tax deduction by the fiduciary or beneficiary.

estate and gift tax returns are audited than all other types of returns filed.[51] And many of those reviewed result in audit adjustments, primarily due to asset revaluations.

While FMV can best be established when a willing buyer and a willing seller agree to a transaction at arm's length, most estate property cannot, need not, or will not be sold. Hence, guidelines have been established to assist with the valuation of specific types of property:

- **Vehicles** [*Schedule F*] – must be valued based at retail, not trade-in value as established by Kelly Blue Book, public auction prices, or a classified advertisement. The vehicle must be sold within a reasonable period following the valuation date and no substantial change may have occurred in the market for similar items.[52]
- **Household items and personal effects** [*Schedule F*] – should be inventoried on a room-by-room basis and each item should be valued individually, except those which are each worth less than $100 may be grouped.[53] NOTE: Some practitioners elect to list "personal property" without identifying details.
- **Checking account** – the balance may be reduced by as-yet uncleared checks written prior to the DOD [*Schedule C*]; the expenses covered by the uncleared checks may be claimed as deductions [*Schedule K*].
- **Gifts and Charities** [*Schedule C*] – checks written by the decedent to a qualified donee but not yet cashed on the DOD are excludable, but uncashed checks to individuals are deemed to be incomplete gifts and must be included on the estate tax return.
- **Publicly-traded stocks and bonds** [*Schedule B*] – must be valued based on the average of the high and low selling prices on the DOD. If the decedent died on a weekend, the highs and lows for the prior Friday and following Monday should be averaged. If the security was not traded on a trading day, the value must be calculated using a weighted average for sales on the nearest sales dates.[54]
- **Mutual funds** [*Schedule B*] – should be valued at the net asset value [NAV] on the DOD. If the DOD occurred on a weekend or holiday, then the NAV from the day preceding should be used.[55]
- **Business or partnership interests** [*Schedule F*] – often difficult to value, many factors should be considered, including the company's net worth, prospective earning power, dividend-paying capacity, goodwill, the industry's economic outlook, the company's position within the industry, and the value of comparable securities.[56] Although no definitive standard exists, discounts may be applied where the shareholder has a minority interest or there is no ready market for the shares.



[51] While less than 1% of all individual income tax returns filed are audited, the rate is roughly 10 times higher for estate and gift tax returns. [As per Brandeisky, *These Are the People Who Are Most Likely to Get Audited*, MONEY, April 14, 2015 (available at http://time.com/money/3820009/irs-tax-audit-chances/, last accessed May 30, 2017)].

[52] Rev. Proc. 65-19.

[53] Treas. Reg. 20.2031-6.

[54] Treas. Reg. §20.2031-2.

[55] Treas. Reg. §20.2031-8(b).

[56] Rev. Rul. 59-60.

- **Real property** [*Schedule A*] – certain property may be eligible for special use valuation based on *current* use rather than *highest and best* use.[57] To be eligible for this election, the property must have been used as a family farm or closely-held business for five of the most recent eight years prior to the DOD *and* continued to be used in the same manner for the next ten years after death. Furthermore, the fair market value of the *real* property must constitute 25% of the gross estate; the combined fair market value of the real *and personal* property must constitute 50% of the gross estate. In other words, special use valuation is available only to the estates of decedents who committed significant portions of their assets to the farm or business endeavor.

  Often it is best to get an appraisal to determine the value of property that cannot otherwise be objectively determined. The IRS requires appraisals that are "qualified" to substantiate taxpayer claims, which means that the appraisal must:
  - Be prepared no earlier than sixty days prior to the date of contribution of the appraised property;
  - Be signed and dated by a qualified appraiser who may not charge a prohibited fee (based on a percentage of the appraised value); and
  - Contain all of the following information: a detailed description of the property, including its physical condition; the date (or expected date) of contribution; the terms of any understanding between the donor and donee regarding the use, sale, or disposition of the property contributed; a statement that the appraisal was prepared for income tax purposes; the date on which the property was appraised; the appraised FMV of the property; the method, basis, and justification of the valuation used; the name, address, and taxpayer identification number of the qualified appraiser, as well as his background and qualifications; and a description of the fee arrangement between the appraiser and the donor.

A qualified appraiser is an individual who holds himself out to the public as an appraiser or performs appraisals on a regular basis; is qualified to make appraisals of this type because of his expertise; is not an excluded individual (i.e. the donor, the donee, or someone affiliated with either); and understands that intentionally false valuations may subject him to penalties.



**ESTATE ASSETS**

- **The personal representative of the estate may elect to value the estate's assets on DOD or AVD, which may only be used if the resulting valuation serves to reduce the estate tax liability.**
- **Assets that did not yet belong to the decedent on DOD are not includible in the gross estate.**
- **However, income that had accrued during life but had not yet been paid to the decedent prior to his death is IRD and is includible as an asset of the estate (*Form 706*) *and* as income to the estate (*Form 1041*) or the beneficiary (*Form 1040*). The pro-rata share of the estate tax allocable to IRD may be claimed as a deduction on the fiduciary's (or beneficiary's) income tax return.**

## V. A Look at the Schedules

The next pages are dedicated to a detailed examination of each of the schedules that comprise the estate tax return and that are used to list assets, expenses, and deductions of the estate. Actual forms, comments and sample entries are provided for ease of reference.

[57] IRC § 2032A.

Powers of Appointment

3 years before death (§ 2035)

Retained Life Estate (§ 2036) - include

Transfers Effective at Death (§ 2037)

Life Insurance (§ 2038)

## SCHEDULE A—Real Estate

- For jointly owned property that must be disclosed on Schedule E, see instructions.
- Real estate that is part of a sole proprietorship should be shown on Schedule F.
- Real estate that is included in the gross estate under section 2035, 2036, 2037, or 2038 should be shown on Schedule G.
- Real estate that is included in the gross estate under section 2041 should be shown on Schedule H.
- If you elect section 2032A valuation, you must complete Schedule A and Schedule A-1.

Special Use Valuation (for family-owned farms & businesses)

[see "Valuation & Appraisals (*supra*)]

| Item number | Description | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|
| 1 | Enter real estate owned in the decedent's name on the DOD.<br><br><u>Sample description</u><br>Personal Residence: 1543 South Cardiff Street, Los Angeles, CA 90030, described as "TRACT # 7671 LOT 106" Parcel # APN 430601402.<br>(Value based on sales price at the close of escrow on May 5, 2009).<br><br>**NOTE 1:** The FMV of a condominium is listed here; however, the FMV of shares owned in a cooperative apartment is reported on Schedule B.<br><br>**NOTE 2:** Assets held in a revocable grantor trust (a.k.a. living trust) should be reported on Schedule G. But to ensure readability and understanding, it is recommended to enter each asset on the appropriate schedule as though it had been held in the decedent's name only and then make a second line entry on that schedule subtracting the FMV and referencing the entry that was transferred to Schedule G. If all of the decedent's assets were held in a living trust, all schedules will be zeroed-out and only Schedule G will have reportable FMV.<br><br><u>Sample entry</u><br>LESS: Value of Personal Residence held in revocable grantor trust entitled The Smith Family Trust DTD September 12, 1989.<br>[See Schedule G].<br><br>**NOTE 3:** Mortgage balance and property taxes for which the estate is liable are listed on Schedule K. If the estate is not liable for the mortgage, list the value of the property less the outstanding mortgage on this schedule. | | | 895,000.<br><br>-895,000. |
| **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 1.) . . . . . . . . . | | | | |

## SCHEDULE B—Stocks and Bonds

(For jointly owned property that must be disclosed on Schedule E, see instructions.)

| Item number | Description, including face amount of bonds or number of shares and par value for identification. Give CUSIP number. If trust, partnership, or closely held entity, give EIN | CUSIP number or EIN, where applicable | Unit value | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|---|---|
| | Enter stocks, bonds, shares of closely-held corporation, and cooperative apartment owned by the decedent on DOD. | | | | | |

Provide a detailed description.
For stocks, include:

- Name of corporation
- Number of shares
- Whether common or preferred
- Price per share
- Listing exchange
- CUSIP number

For bonds, include:

- Name of issuer
- Quantity & denomination
- Date of maturity
- Interest rate & payable dates
- Listing exchange
- CUSIP number

Be sure to include even worthless (bankrupt) securities held by the decedent.

| | Security Description | High/Ask | Low/Bid | Mean and/or Adjustments | Div and Int Accruals | Security Value |
|---|---|---|---|---|---|---|
| 1) | 400 COHEN & STEERS REIT & PFD INCM (19247X100)COM New York Stock Exchange 10/01/2009 | 9.86000 | 9.55000 H/L | 9.705000 | | 3,882.00 |
| 2) | 2900 CONSOLIDATED EDISON INC (209115104)COM New York Stock Exchange 10/01/2009 | 41.73000 | 40.76000 H/L | 41.245000 | | 119,610.50 |
| 3) | 1218 EXELON CORP (30161N101)COM New York Stock Exchange 10/01/2009 | 49.79000 | 48.49000 H/L | 49.140000 | | 59,852.52 |
| 4) | 5000 FRANKLIN CUSTODIAN FDS INC (353496300)INCOME FD CL A Mutual Fund (as quoted by NASDAQ) 10/01/2009 | | 1.96000 Mkt | 1.960000 | 62.50 | 9,800.00 |

CUSIPs are 9-digit alphanumeric codes issued by the Committee on Uniform Security Identification Procedures which uniquely identify any North American security for the purposes of facilitating clearing and settlement of trades. QuantumOnline.com offers a free CUSIP look-up service.

Valuation may best be obtained from Estate Valuations & Pricing Systems, Inc. [EVP], a national leader in providing ready-to-file historical securities valuations for Form 706. The IRS uses EVP to verify all pricing on Form 706. Most EVP evaluations cost $1.55 per CUSIP. [More information available at http://www.evpsys.com/, last accessed September 16, 2015.]

Sample entry:

7,737.097sh Franklin Income Fund, NASDAQ Symbol FKINX (valued at net asset value at market close on March 27, 2008).

Accrued dividends are includible on Form 706 if the decedent died between the ex-dividend and payable dates. [Remember "DeRP".]

| Item number | Description | CUSIP number or EIN | Unit value | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|---|---|
| 1 | 7,737.097sh Franklin Income Fund, NASDAQ Symbol FKINX | | 2.42 | | | 18,724. |
| 1a | Accrued dividends | | | | | 84. |

## SCHEDULE C—Mortgages, Notes, and Cash

(For jointly owned property that must be disclosed on Schedule E, see instructions.)

| Item number | Description | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|
| 1 | Sample entries:<br>City National Bank, 9229 Sunset Boulevard, West Hollywood, CA, Senior Checking Account # 6517435 ($80,527.42 balance on 3/20/08, less $5,624.64 checks cleared prior to 3/27/08). | | | 74,903. |
| 1a | Accrued Interest: City National Bank. | | | 15. |
| 2 | Federal income tax refund, 2007 Form 1040, received post-death (IRD). | | | 5,856. |
| 3 | Credit for property taxes paid on personal residence [see Schedule A, Item # 1] rebated to buyer at close of escrow on May 14, 2008 (IRD). | | | 1,332. |
| Total from continuation schedules (or additional sheets) attached to this schedule. . | | | | |
| **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 3.) . . . . . . . . . | | | | |



## SCHEDULE D—Insurance on the Decedent's Life

You must list all policies on the life of the decedent and attach a Form 712 for each policy.

| Item number | Description | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|
| | All insurance policies on the decedent's life must be reported here.<br><br>If the decedent owned the policy, enter value at DOD (or AVD). If the decedent did not own the policy, only a description of the policy but not its value is entered.<br><br>An Irrevocable Life Insurance Trust (ILIT) can be used to obtain life insurance on an individual without granting any incidents of ownership to that individual; as a result, a policy held in an ILIT is not includible in a decedent's estate.<br><br>**Form 712 Life Insurance Statement** (detailed description of the policy as provided by the insurance company) must be attached to the estate tax return. | | | |
| 1 | Sample entry:<br>Improbable Life of America, P.O. Box 22, Hartford, CT 23234, Universal Life II Policy # 000-UW000836, policy proceeds to benefit Alice Alligator (50%) and Beverly Alligator Trust (50%), issued January 1, 1995, $1,400,000 face value less $258,024 policy loan. | | | 1,141,976. |
| Total from continuation schedules (or additional sheets) attached to this schedule . . . | | | | |
| **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 4.) . . . . . . . . . | | | | |

## SCHEDULE E—Jointly Owned Property

(If you elect section 2032A valuation, you must complete Schedule E and Schedule A-1.)

### PART 1. Qualified Joint Interests—Interests Held by the Decedent and His or Her Spouse as the Only Joint Tenants (Section 2040(b)(2))

| Item number | Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN | CUSIP number or EIN, where applicable | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|---|
| | | | | | |
| Total from continuation schedules (or additional sheets) attached to this schedule . . . . . . | | | | | |
| **1a** Totals . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | | **1a** | |
| **1b** Amounts included in gross estate (one-half of line **1a**) . . . . . . . . . . . . . | | | | **1b** | |

Report property held by decedent and spouse in joint tenancy with right of survivorship (JTWROS) or tenants in common. Community property assets are *not* reported here but must be listed on each appropriate schedule with a 2nd line entry removing the value of the spousal portion from the total FMV. The spouse's ½ share is then included on Schedule M.

Include the full amount of the asset's FMV.

### PART 2. All Other Joint Interests

**2a** State the name and address of each surviving co-tenant. If there are more than three surviving co-tenants, list the additional co-tenants on an attached sheet.

| Name | Address (number and street, city, state, and ZIP code) |
|---|---|
| **A.** | |
| **B.** | |
| **C.** | |

| Item number | Enter letter for co-tenant | Description (including alternate valuation date if any). For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN | CUSIP number or EIN, where applicable | Percentage includible | Includible alternate value | Includible value at date of death |
|---|---|---|---|---|---|---|
| 1 | | | | | | |
| Total from continuation schedules (or additional sheets) attached to this schedule . . . . . . | | | | | | |
| **b** Total other joint interests . . . . . . . . . . . . . . . . . . . . . . | | | | | **2b** | |
| **3 Total includible joint interests** (add lines 1b and 2b). Also enter on Part 5—Recapitulation, page 3, at item 5 . . . . . . . . . . . . . . . . . . . . . . . . . | | | | | **3** | |

Report decedent's property held jointly with someone other than his spouse here.

Include only a prorated share of the FMV if the joint tenant contributed to the asset or gave consideration in exchange for receiving title to the property.

## SCHEDULE F—Other Miscellaneous Property Not Reportable Under Any Other Schedule

(For jointly owned property that must be disclosed on Schedule E, see instructions) (If you elect section 2032A valuation, you must complete Schedule F and Schedule A-1.)

| | | Yes | No |
|---|---|---|---|
| 1 | Did the decedent own any works of art, items, or any collections whose artistic or collectible value at date of death exceeded $3,000? . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . If "Yes," submit full details on this schedule and attach appraisals. | | |
| 2 | Has the decedent's estate, spouse, or any other person received (or will receive) any bonus or award as a result of the decedent's employment or death? . . . . . . . . . . . . . . . . . . . . . . . . . . . If "Yes," submit full details on this schedule. | | |
| 3 | Did the decedent at the time of death have, or have access to, a safe deposit box? . . . . . . If "Yes," state location, and if held jointly by decedent and another, state name and relationship of joint de<br><br>If any of the contents of the safe deposit box are omitted from the schedules in this return, explain fully wh | | |

These questions must be answered – if "yes", additional information must be provided by attachment.

| Item number | Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN | CUSIP number or EIN, where applicable | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|---|
| 1 | | | | | |

Enter decedent's assets and other property that has not been reported on other schedules.

<u>Sample entries:</u>

1. Automobile: 1988 Mercedes Benz 300 SDL Turbo Diesel, 4-door sedan with custom interior (as appraised by Barney Oilfield & Company)

2. Personal Property: Furniture, furnishings & artworks (as appraised by Sothebee, Krispies & Co.)
   LESS: 1/2 of community property attributable to spouse ($13,750)

3. Golden State Investment Company, 25% interest in a California general partnership (as appraised by Lawrence Lion).

Don't know which schedule to use?

Use Schedule F to list *any* item that does not seem to fit on another schedule – be sure to never omit an asset or liability just because you're uncertain of its proper placement. Schedule F may not be the right place for it, but at least the decedent's estate will have been described in full. Substance over form will prevail!

Items listed on this schedule are generally those which are testamentary in nature, or revocable by the grantor, or those which do not cede beneficial ownership in a timely manner. For example, a charitable lead trust (CLAT) – if properly structured (as per Ltr. Rul. 9335014) – should qualify as a *non*-grantor trust which would no longer be a part of the decedent's estate and, therefore, not listed here.

## SCHEDULE G—Transfers During Decedent's Life

(If you elect section 2032A valuation, you must complete Schedule G and Schedule A-1.)

| Item number | Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|
| A. | Gift tax paid or payable by the decedent or the estate for all gifts made by the decedent or spouse within 3 years before the decedent's death (section 2035(b)):<br><br>§ 2035 is intended to prevent "deathbed" transfers of certain assets gifted within 3 years prior to the decedent's passing. Both the asset and the gift tax paid on transfer must be added back to the estate for transfers of:<br>• The decedent's life insurance policy<br>• Retained interests, whereby the decedent retained the right to income, possession or enjoyment of property that was otherwise transferred<br>• Asset transfers which take place at death<br>• Reversionary and revocable interests<br><br>**NOTE 1:** Outright gifts – even those made within 3 years of death – are not includible.<br><br>**NOTE 2:** Assets gifted by the trustee of a revocable trust are not includible. | | | |
| B. | Transfers includible under section 2035(a), 2036, 2037, or 2038:<br><br>§2036: Decedent retained right to lifetime income or possession, e.g. dad gave house to daughter but continued to live in the home & pay for its upkeep (no effective change of ownership).<br><br>§ 2037: Includes transfers which were not effectuated until death or where decedent maintained unfettered control during life, e.g. trustor retained the right to distribute some or all of corpus to beneficiary at any time (early termination). But power to invade principle for "special needs" for support and education of beneficiary do not trigger inclusion [Rev Rul 73-143].<br><br>§ 2038: Revocable transfers including grantor trusts and custodial accounts where the donor is the custodian.<br><br><u>Sample entry</u><br>Personal Residence.<br>[See Schedule A for full description]. | | | |
| Total from continuation schedules (or additional sheets) attached to this schedule . . . | | | | |
| **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 7.) . . . . . . . . . | | | | |

The gift tax that was paid is reported on Line A; the assets that were transferred are reported on Line B.

Ader gifted 1/5 of his 1,100 acre ranch to each of his 5 children in 1965 but retained "full use, control, income and possession of the property for life." The property was worth $6.39 million in 2004 when Adler died; his executor sought to claim a 32% marketability discount and 16% minority-interest discount. The Court disallowed the discounts since the property would not be split until *after* Adler's death and he effectively owned *all* of the property on DOD.

Beware of UTMA accounts!

**NOTE:** Cross-reference with Schedule A for ease of understanding.

DEFINITION

A retained life estate (IRC § 2036) includes assets which the decedent has reserved the right to possess or enjoy the income therefrom, even though he claims to have gifted the property. In other words, sufficient strings were attached to the gift by the donor to prevent the donee from having full and complete beneficial ownership

## SCHEDULE H—Powers of Appointment

(Include "5 and 5 lapsing" powers (section 2041(b)(2)) held by the decedent.) (If you elect section 2032A valuation, you must complete Schedule H and Schedule A-1.)

| Item number | Description | Alternate valuation date | Alternate value | Value at date of death |
|---|---|---|---|---|
| 1 | A power of appointment [POA] authorizes an individual to control the disposition of certain property. Because a general POA allows the grantor to exercise the power in favor of himself, his creditors, his estate or his estate's creditors, the property subject to this power is includible in the grantor's estate. If the power is exercised during the grantor's life, a gift tax liability will arise.<br><br>If the POA was limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent, the subject property is not includible in the estate. Examples of proper wording include powers exercisable for the holder's "support," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," and "medical, dental, hospital and nursing expenses and expenses of invalidism."<br><br>A lapsed power is considered released (and not includible) if the subject property exceeded the greater of $5,000 or 5% of the total value of all subject properties at the time of the lapse. | | | |
| | Total from continuation schedules (or additional sheets) attached to this schedule | | | |

Make sure to attach copy of instrument granting the POA to the estate tax return.

Prior to 1985, the fiduciary could elect to exclude lump-sum annuity distributions that were previously included in the decedent's taxable wage income. This question should almost always be answered "no".



## SCHEDULE I—Annuities

**Note.** Generally, no exclusion is allowed for the estates of decedents dying after December 31, 1984 (see instructions).

**A** Are you excluding from the decedent's gross estate the value of a lump-sum distribution described in section 2039(f)(2) (as in effect before its repeal by the Deficit Reduction Act of 1984)? . . . . . . . . . . . . . If "Yes," you must attach the information required by the instructions. | Yes: | **No**

| Item number | Description. Show the entire value of the annuity before any exclusions | Alternate valuation date | Includible alternate value | Includible value at date of death |
|---|---|---|---|---|
| 1 | An annuity results from the transfer of money or property in exchange for the promise of an income stream. The value of the annuity is includible in the decedent's estate if the income stream – whether paid to the decedent or his beneficiary – did not end before death. Examples include pension and retirement plans.<br><br>The amount includible is the amount proportionate to the purchase price contributed by the decedent or his employer.<br><br><u>Sample entry:</u><br>Automatic Pilot Insurance Company, Hartford, CT, Individual Retirement Account # 4G-H-774567. (No Minimum Required Distributions or other withdrawals required--no reportable IRD.) | | | 129,306. |
| | Total from continuation schedules (or additional sheets) attached to this schedule . . . | | | |
| | **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 9.) . . . . . . . . . | | | |

DEFINITION

An annuity results from the transfer of money or property in exchange for the promise of an income stream and is includible in the decedent's estate if that income stream – whether paid to the decedent or his beneficiary – did not end before death. As such, pension, profit-sharing and retirement plans (Traditional, ROTH and SEP IRAs) are reportable on this schedule.

## SCHEDULE J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims

**Note:** If executors' commissions, attorney fees, etc., are claimed and allowed as a deduction for estate tax purposes, they are not allowable as a deduction in computing the taxable income of the estate for federal income tax purposes. They are allowable as an income tax deduction on Form 1041, U.S. Income Tax Return for Estates and Trusts, if a waiver is filed to waive the deduction on Form 706 (see Instructions for Form 1041).

| Item number | Description | Expense amount | Total amount |
|---|---|---|---|
| | **A. Funeral expenses:** | | |
| 1 | | | |
| | Total funeral expenses . . . . . . . . . . . . . . . . . ▶ | | |
| | **B. Administration expenses:** | | |
| | **1** Executors' commissions—amount estimated/agreed upon/paid. (Strike out the words that do not apply.) . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | |
| | **2** Attorney fees—amount estimated/agreed upon/paid. (Strike out the words that do not apply.) . . | | |
| | **3** Accountant fees—amount estimated/agreed upon/paid. (Strike out the words that do not apply.) . . | | |
| | **4** Miscellaneous expenses: | Expense amount | |
| | Total miscellaneous expenses from continuation schedules (or additional sheets) attached to this schedule . . . . . . . . . . . . . . . . . . . . . . . . . . . | | |
| | Total miscellaneous expenses . . . . . . . . . . . . . . . . . . . . . . . . . ▶ | | |
| | **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 13.) . . . . . . . . . . . . ▶ | | |

Deductible *only* on Form 706. Total funeral expenses must be reduced by death benefits received from SSA or VA.

Must be substantiated.

Personal representative may make separate election to deduct *each* administrative expense on *either* Form 706 or 1041 [IRC § 642(g)].

Sample entries:

A. Neptune Society, for transport, cremation and placement.
B. Probate Court Costs, certified copies, & appraisal fees.

## SCHEDULE K—Debts of the Decedent, and Mortgages and Liens

| Item number | Debts of the Decedent—Creditor and nature of claim, and allowable death taxes | Amount unpaid to date | Amount in contest | Amount claimed as a deduction |
|---|---|---|---|---|
| 1 | Enter all unpaid obligations of the decedent (except mortgages) here:<br>• Property taxes if accrued before death; those accrued post-death must be claimed on **Form 1041**.<br>• Medical expenses incurred by the decedent are deductible *only* on **Form 706**. (Insurance reimbursements received after DOD are reported as income on **Form 1041**.)<br>• Income taxes due on decedent's final **Form 1040** must be deducted here.<br>• Decedent's Miscellaneous Itemized Deductions unpaid before death are deductible only on **Form 1041** subject to the 2% AGI limitation.<br><br>If **Form 706** is not filed, expenses deductible only on the estate tax return are forfeited.<br><br><u>Sample entries:</u><br>Property taxes for 2006-07 tax year (ending July 1, 2006) on 1234 Pond Street, Los Angeles, CA accrued and unpaid prior to decedent's death. [See Schedule A.] | | These are entered below. | 7,100. |
| | Unpaid credit card bill paid after DOD - European Express Gold Card, for balance due July 31, 2006. | | | 5,679. |
| | Total from continuation schedules (or additional sheets) attached to this schedule . . | | . . . . . . | |
| | **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 14.) . . . . . . . | | . . . . . . | |

| Item number | Mortgages and Liens—Description | Amount |
|---|---|---|
| 1 | Obligations secured by mortgages and other liens on property may be claimed only if the estate is liable for the debt.<br><br><u>Sample entry:</u><br>GMAC purchase money mortgage secured by deed of trust on primary residence [see Schedule A ], $600,000 face amount, dated January 1, 1994, 30-year note due December 31, 2024, 8.5% annual interest accrued monthly, $4,613.48 monthly installments, last paid August 1, 2006, balance due on date of death includes $1,186 accrued interest. | 503,520. |
| | Total from continuation schedules (or additional sheets) attached to this schedule . . . . . . . . | |
| | **TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 15.) . . . . . . . . . . . . | |



## SCHEDULE L—Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims

- Report unreimbursed theft and casualty losses incurred during the administration period of the estate.
- If AVD is used, no deduction is allowed for any decrease in asset valuations.
- Depreciation is not deductible on **Form 706**.

## SCHEDULE M—Bequests, etc., to Surviving Spouse

| | | | Yes | No |
|---|---|---|---|---|
| 1 | Did any property pass to the surviving spouse as a result of a qualified disclaimer? If "Yes," attach a copy of the written disclaimer required by section 2518(b). | 1 | | |
| 2a | In what country was the surviving spouse born? | | | |
| b | What is the surviving spouse's date of birth? | | | |
| c | Is the surviving spouse a U.S. citizen? | 2c | | |
| d | If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship? | | | |
| e | If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen? | | | |
| 3 | **Election Out of QTIP Treatment of Annuities.** Do you elect under section 2056(b)(7)(C)(ii) not to treat as qualified terminable interest property any joint and survivor annuities that are included in the gross estate and would otherwise be treated as qualified terminable interest property under section 2056(b)(7)(C)? (see instructions) | 3 | | |

| Item number | Description of property interests passing to surviving spouse. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN | Amount |
|---|---|---|
| A1 | QTIP property: | |
| B1 | All other property: | |
| | Total fr | |

Use this form to report non-taxable transfers between spouses (eligible for the unlimited marital deduction).

Property that should be included here:

- Specific bequests to surviving spouse
- Life insurance benefits
- Survivor's statutory interest
- Community property interest
- Qualified Domestic Trust for non-citizen spouse

Do not include any property disclaimed by surviving spouse.

QTIP = Surviving spouse receives income for life, then property passes to 3rd party.

Eligible for marital deduction if (1) spouse receives all of the income (2) for life (3) at least annually, and (4) no one has power to change income beneficiary.

QTIP election, once made, is irrevocable.

Sample entries:

1/2 of the value of bank accounts: Marble Beach Checking ($53,930) and Reptilian Mutual Savings ($72,713), held as joint tenants with right of survivorship [See Schedule E, Part 1].

Remaining property in excess of Decedent's Exemption ($3,500,000) not allocated to The John Doe Decedent's Trust (EIN # 22-6410000) is hereby allocated to the surviving spouse as per Asset Allocation Statement. [See Supporting Documents attached.]

| | | | | | |
|---|---|---|---|---|---|
| 4 | **Total** amount of property interests listed on Schedule M | | | 4 | |
| 5a | Federal estate taxes payable out of property interests listed on Schedule M | 5a | | | |
| b | Other death taxes payable out of property interests listed on Schedule M | 5b | | | |
| c | Federal and state GST taxes payable out of property interests listed on Schedule M | 5c | | | |
| d | Add items 5a, 5b, and 5c | | | 5d | |
| 6 | Net amount of property interests listed on Schedule M (subtract 5d from 4). Also enter on Part 5—Recapitulation, page 3, at item 20 | | | 6 | |

**SCHEDULE O—Charitable, Public, and Similar Gifts and Bequests**

| | | Yes | No |
|---|---|---|---|
| 1a | If the transfer was made by will, has any action been instituted to contest or have interpreted any of its provisions affecting the charitable deductions claimed in this schedule? . . . . . . . . . . . . . . . . . . . If "Yes," full details must be submitted with this schedule. | | |
| b | According to the information and belief of the person or persons filing this return, is any such action planned? . If "Yes," full details must be submitted with this schedule. | | |
| 2 | Did any property pass to charity as the result of a qualified disclaimer? . . . . . . . . . . . . . . . If "Yes," attach a copy of the written disclaimer required by section 2518(b). | | |

| Item number | Name and address of beneficiary | Character of institution | Amount |
|---|---|---|---|
| 1 | | | |

A charitable deduction may be claimed for the value of property included in the decedent's estate that was transferred to a qualified organization by the decedent during lifetime or after death by will (trust).

Eligible transfers include direct contributions, charitable remainder trusts, pooled income funds, and charitable lead trusts.



## VI. Stepped-up Basis

The heir to a decedent's property receives what is known as "stepped-up basis." Unlike gifts, inherited property is assigned a basis equal to its value as claimed on **Form 706**. If no estate tax return is filed, the basis is the FMV on the DOD.[58] Because we assume that most property increases in value throughout the decedent's lifetime, we assume that property is worth more on the DOD than when originally acquired—hence, we assume that basis is increased or stepped-*up* at death. However, values can also decline and so basis may, on occasion, be stepped-*down*.

**<u>Joint Assets and Community Property</u>**

This step-up or step-down is applied to all property acquired from a decedent, whether that property has passed through probate, by operation of law, or by contract. For jointly-held property, only that portion that is includible in the decedent's estate receives the step-up or step-down. NOTE: The entire value of the property is included in decedent's estate and receives a stepped-up basis, unless the joint tenant contributed to or provided consideration for his portion of the jointly-held property.

On the other hand, only one-half of qualified joint interests—properties held exclusively by the decedent and spouse, both of whom must be U.S. citizens—are included in the decedent's estate and receive only one-half stepped-up basis.[59] Similarly, if the assets are held in community property,

[58] IRC § 1014 has been amended to mandate that inherited property may not have a higher basis than that which was reported for estate tax purposes. In fact, estates that file **Form 706** must issue informational statements disclosing the value of property listed on the estate tax return to all beneficiaries who receive transferred property from the estate [IRC § 6035]. These statements must be filed with the IRS and affected beneficiaries within 30 days after filing **Form 706** (or the date the estate tax return is due) beginning June 30, 2016 [IRS Notice 2016-27].

[59] IRC §§ 2040(b) and 2056(d).

only the decedent's one-half share must be included in the estate although the basis of the surviving spouse's share of the community property will be stepped-up along with the decedent's portion.[60]

**Additional Rules**

Basis revaluation does not apply to IRD assets; annuity payments and lump-sum payouts received to the extent that they exceed the decedent's investment in the contract;[61] excludable life insurance proceeds paid because of the insured's death; or appreciated property given to the decedent within one year of death that reverts from the decedent back to the original donor.[62]

Capital gains from the sale of inherited property are always considered to be long-term, even when the property is sold less than one year after its receipt.[63]

**2010 – The Exception**

The rules outlined here apply to the estates of decedents who died prior to January 1, 2010 or after December 31, 2010, but estates resulting from *deaths occurring during the calendar year of 2010* were subject to special rules. During that period, the estate tax exclusion was raised to an unlimited amount, which meant that estates passed tax-free to heirs and assets were not revalued. This, in turn, meant that heirs did not receive a stepped-up basis, but rather assumed the decedent's basis (and holding period) and often inherited tremendous capital gain exposure.

However, the fiduciary could allocate up to $1.3 million of value to the heir's basis, although the new basis could not exceed the FMV on the DOD. (The increase for non-resident, non-citizen decedents was limited to $60,000.) The fiduciary could also allocate an additional $3 million of basis to assets passing to a surviving spouse or qualified terminable interest property [QTIP].[64]

Last-minute legislation in late 2010 not only re-introduced the estate tax exclusion and stepped-up basis, but also allowed estates of 2010 decedents to be taxed under the rules in effect for 2011.[65] Since 2011 rules were generally more favorable for most estates, the IRS presumed that an *automatic* election was made to operate under these rules unless an *affirmative* election was made by filing **Form 8939 Allocation of Increase in Basis for Property Acquired from a Decedent**.

**Basis Reporting**

To ensure that the decedent's beneficiaries use the estate's reported values on the estate tax return as the basis of all inherited assets, the fiduciary must file **Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent** to report the value of each beneficiary's acquired interest in the decedent's estate.[66] This form must be filed within 30 days after a timely



[60] Rev. Rul. 68-80 and 87-98.

[61] IRC §§ 1014(b)(9) and 72; Rev. Rul. 2005-30.

[62] IRC §1014(e).

[63] IRC § 1223(11).

[64] A type of trust that enables the grantor to provide for a surviving spouse and also to maintain control of how the trust's assets are distributed once the surviving spouse has also died. Income, and sometimes principal, generated from the trust is given to the surviving spouse to ensure that he or she is taken care of for the rest of his or her life. [Definition available at http://www.investopedia.com/terms/q/QTIP.asp#ixzz1tjB4lJrq (last accessed May 30, 2017)].

[65] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act § 301(c).

[66] IRC § 6035(a)(1) and (2).

estate tax return is filed and must be re-submitted if a valuation adjustment is made based on an IRS examination or court determination.[67] The filing requirement applies only to those estates which must file **Form 706** because the filing threshold has been exceeded and not to those estates which submit a return merely to elect DSUE portability.[68]

Schedule A which is used to identify and cross-reference each asset transferred to an heir with entries on **Form 706**, must be provided to the IRS (with **Form 8971**) as well as each beneficiary (without **Form 8971**). All property included in the decedent's gross estate must be reported except cash, IRD assets, unappraised tangible personal property , and property sold by the fiduciary during the administration of the estate.[69]

The penalty for failure to timely file **Form 8971** and **Schedule A** with the IRS begins at $50 and increases after a 30-day delay. The minimum penalty for intentional disregard is $530. Failure to timely furnish Schedule A *to each beneficiary* begins at $50 per Schedule A and increases after a 30-day delay; the maximum penalty could be as high as $3,193,000/year [yes, $3 million – you read right!!!] (All penalty amounts will be adjusted for inflation.)

**STEPPED-UP BASIS**

- **A beneficiary generally enjoys a basis step-up as assets are revalued on the DOD (or AVD).**
- **Joint assets receive only ½ step-up but community property assets receive a full step-up.**
- **Assets inherited from decedents who died in 2010 were subject to special rules in effect for only that year: The fiduciary could elect to use the decedent's carry-over rather than stepped-up basis.**
- ***Form 8971* must be filed with the IRS and furnished to each beneficiary to ensure consistent basis reporting.**



## VII. Audit Prevention

In 2009, just over forty-two thousand estate tax returns were filed and 10% of those were audited by the IRS; in 2010, only twenty-three thousand returns were filed but more than 18% were audited; by 2015, nearly 36,000 returns were filed and roughly 8% of those were audited. While auditors have traditionally focused on returns of estates valued in excess of $10 million, even small and mid-size estates are not disregarded with up to 16% reviewed in recent years. And practically none of the returns examined survived scrutiny without change![70]

With such unnerving statistics, taxpayers and practitioners are looking for the panacea, the magic fix ensuring an audit-free **Form 706**. Alas, I cannot offer you that guarantee, but I can offer tips to help reduce the likelihood of audit and increase the chance of survival in the event the return is examined.

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[67] IRC § 6035(a)(3)(A).

[68] The filing requirement applies to all estate tax returns due after July 31, 2015, although the due date to submit **Form 8971** which was previously unavailable was postponed for the third time until June 30, 2016 [IRS Notice 2016-27].

[69] Treas. Reg. § 1.6035-1(b).

[70] Statistics provided by *SOI Tax Stats - Examination Coverage: Recommended and Average Recommended Additional Tax after Examination - IRS Data Book Table 9a* for last available calendar year [available at http://www.irs.gov/uac/SOI-Tax-Stats-Examination-Coverage:-Recommended-and-Average-Recommended-Additional-Tax-After-Examination-IRS-Data-Book-Table-9a (last accessed May 30, 2017)].

Generally, "audit triggers" involve highly subjective valuations, non-compliance, and poor recordkeeping. The latter should be the easiest to address.

**Attachments**

While several schools of thought prevail when preparing individual income tax returns with some practitioners espousing more rather than less disclosure and others adopting a less-is-more-attitude, most 706 preparers agree that is it best to provide as much information as possible at the time of filing in hopes of preempting further inquiry. The following items – at a minimum – should be attached to every 706. Additional items, when relevant, should be included as well.

- Certified copy of death certificate.
- Estate planning documents and governing instruments (e.g., will or trust).
- Any previously-filed gift tax returns.
- Pre- and post-nuptial agreements.
- Agreements regarding property held in joint tenancy or community property.
- **Form 56 Notice Concerning Fiduciary Relationship** – required to notify IRS of personal representative's authority to act on behalf of the estate.
- Supporting documentation to substantiate *all* entries on **Form 706**, including appraisals, bank and brokerage statements, escrow statements, property tax invoices, etc.

**"Top Ten" Audit Triggers**[71]

1. Large gross estate – the larger the estate, the greater the chance of audit.
2. Substantial real estate holdings – particularly commercial and agricultural holdings.
3. Closely-held stock – discounted valuations are inevitably questioned by the IRS.
4. Life insurance excluded from the estate – the IRS seeks to ascertain whether the decedent had any incidents of ownership that would require inclusion in the estate.
5. Jointly-held property – transfers between family members and consideration given in exchange for title to assets are often poorly documented.
6. Personal property – frequently over-looked and not reported.
7. Deathbed transfers.
8. Marital deduction – the IRS often looks to the wording in estate planning and other ancillary documents to ensure that the estate is entitled to the deduction.
9. Alternate valuation – must satisfy the stringent rules applicable to AVD.
10. Special use valuation – valuation may be artificially and incorrectly depressed.

**Make it Look Good**

As you can see, no schedule is left unscathed; whether the examiner is looking for ministerial errors or valuation misstatements. Diligence when preparing the return is mandatory. Avoid a deficient appraisal by ensuring that it is as specific as possible, does not use boilerplate language, thoroughly substantiates any valuation discounts applied, is clear and understandable, and does not include arithmetic errors. Explain any valuations that may appear to be lower than expected.[72] And make sure that the submitted return looks professional, is easy to read, and does not include typographical errors.



[71] Gagliardi, Burke & Friel, *Preventing an IRS Audit of an Estate Tax Return.*

[72] Jill Miller, *Common Estate Tax Audit Triggers and How to Avoid Them*, excerpted by RIA Newsstand (December 17, 2007).