

Preparing a Federal Estate Tax Return – Form 706

By Yahne Miorini, LL.M.

There are 5 parts in the Form 706, 9 schedules to determine the gross estate, and 7 schedules for deductions. It is a good practice to include all of the schedules and mark "0" on those schedules that do not show any assets, exclusions, or deductions.

Part 1 - Decedent and Executor. In Part 1, the fiduciary will provide information on the decedent and the executor. The executor means the executor, personal representative, or administrator of the decedent's estate. If none is appointed, every person in actual or constructive possession of any property of the decedent, is considered an executor by the IRS, and must file the return. Note that on Part 1.3b, the fiduciary will report the year the decedent's domicile was established, and on Part 1.7a and b, information on the probate procedure.

When there are several fiduciaries, the information on the additional fiduciaries needs to be attached to the return. Each fiduciary will sign the return at the bottom of the first page with the tax preparer. If the fiduciaries are unable to join in making one complete return, each is required to file a separate return disclosing all the information the person has in the case, including the name of every person holding an interest in the property and a full description of the property.

You must attach to the return a certified copy of the death certificate, a certified copy of the will

when the decedent died testate, and a copy of the form 4768 if an extension has been granted.

Part 2 - Tax Computation The tax calculation is summarized in Part 2.

Part 3 - Elections by the Executor. In Part 3 the fiduciary may make some elections regarding the valuation of the gross estate. The fiduciary will need to report the fair market of the assets as of the date of death. A fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.

Exceptions to this general rule include the election of the alternate valuation date under I.R.C. § 2032 and the election of a special use valuation under I.R.C. § 2032A. If timely elected, the alternate valuation date is the date that is six months after the decedent's date of death, unless the property is sold before such date. If property is sold or disposed of during the six-month period, the value of the date of sale or disposal governs the value of the property. The section 2032 election may be made only if the net result decreases the value of the gross estate, and the estate tax due.

The fiduciary makes the election to use the alternate valuation date by checking the box on Part 3, line 1, page 2 of the Form 706 and by completing

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all of the alternate value columns on Schedule A through I.

The fiduciary can round off to whole dollars all of the assets reported. The fiduciary shall drop any amount less than 50 cents and increase any amount for 50 cents through 99 cents to the next higher dollar amount.

Part 4 - General Information. This is where the tax preparer will provide his/her identity and sign a second time the return. Additional information on the decedent will be reported in this section. Information on the beneficiaries is reported in this part with tax information including information on gift tax returns and none probate assets such as trusts, Generation-skipping transfers, power of appointments and interest in closely held corporation.

Part 5 – Recapitulation. This is a summary of all of the schedules of the return. There are 9 schedules (Schedules A through I) to complete on Form 706 to determine the gross estate and 7 schedules (Schedules J through O and Schedule U) available for deductions.

Schedule A – Real Estate. All interest of the decedent in specified real estate¹, mineral interest², easements on land, condominiums³, fractional share

of any tenancy in common, interest in real estate sales contracts, and extra cemetery lots with marketable value⁴.

Real estate interest should be appraised and the appraisal must be attached to the return. The tax-assessed value is not sufficient. However, the requirement of an appraisal is waived when the real estate is sold within a year from the date of death. Then the sale price is the value to be reported on the Form 706.

The fiduciary may apply a discount for fractional share of interest including tenancy in common. A 10% to 25% discount is acceptable. However, before using a discount you should check on the last position of the IRS regarding discounts.

It's under this schedule that the fiduciary will make election to value certain farm and closely held business property. This discussion is beyond the scope of this class.

Schedule B – Stocks and Bonds. All stocks and bonds owned individually or as tenant in common, are reported on Schedule B, including shares in mutual funds and brokerage money market accounts. Accrued interest and dividends are reported as separate items on this schedule.

¹ Growing crops is listed on Schedule F.

² Royalty interest is listed on Schedule F.

³ Co-ops rights are reported on Schedule B.

⁴ Not the decedent's cemetery lot and any lots reserved for use by members of the decedent's family.

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The fair market value (FMV) is the mean between the highest and lowest selling prices quoted on the valuation date. When the death occurs on a weekend or federal holiday the average of the mean between the highest and lowest selling prices on the nearest trading date before and after the valuation date shall be used.

Accrued dividends are dividends that were declared to stockholders of record on or before the date of death.

Schedule C – Mortgages, Notes, and Cash.

Mortgages, notes, certificates of deposit, checking accounts, and savings accounts owned individually by the decedent are reported on this schedule. The fiduciary must carefully consider valuation issues relating to mortgages and notes, including discounts resulting from below-market interest rates.

Schedule D – Life Insurance. All life insurance policies on the decedent's life whether or not it included in the decedent's estate must be reported. This includes flight insurance and often-overlooked policies that are part of financing arrangements for automobiles, credit cards, and mortgages.

Form 712 for each policy must be attached to the Form 706. The fiduciary must answer Part 4.8(a) question on page 3 of the Form 706 by stating whether there is any insurance on the decedent's life that is not included in the gross estate. If any such insurance is excluded from the gross estate, a

detailed explanation must be provided. Whether insurance on the life of the decedent should be included in the gross estate may be a complicated issue involving the analysis of complex rules, case law, and factual determinations.

Interest paid on insurance proceeds by an insurance company after the date of death is reported on the estate's income tax return and is not reported on the Form 706.

Schedule E – Jointly-Owned Property. All joint ownership interests are reported on this schedule, which has two parts. Interests included are real estate, stocks, bonds, bank accounts, and personal property such as boats, cars, airplanes, and mobile home.

Part I covers interests owned with the decedent's spouse. There is a presumption for married couples, who owned property tenant by the entirety or jointly with right of survivorship, that each owns a 50 per cent interest. This presumption applies only to US citizen⁵. In addition, there is an exception called Gallenstein exception for real estate properties owned before 1976. When a joint property was acquired before 1977 and the decedent paid 100% of the value of the property, that 100% of the property value is can be included in the decedent's gross estate⁶. The surviving spouse will

⁵ See I.R.C. Section 2523(i)(3).

⁶ See Gallenstein, M. Lee v. U.S. (1992, CA6) 70 AFTR 2d 92-5683, 975 f2d 286.

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be entitled to a stepped-up date-of-death basis for the entire property.

Part II covers all interest owned jointly not between spouse⁷. There is a rebuttable presumption that includes the full value of the joint property in the decedent's estate for all non-spousal joint interests. The presumption is rebuttable only by establishing that part of the property originally belonged to or was contributed by the other joint owner.

Schedule F – Miscellaneous Property. This is the catchall schedule for all property not reported on any other schedule. A list of the assets to be reported on this schedule is provided in the instructions for Schedule F, page 20 of Form 706. The fiduciary will also answer the questions in Part 4 on lines 6, 8(b), 10, and 12(b).

Tangible personal properties shall be reported on this schedule. It is recommended to have the tangible appraised by an expert under oath. Any article's value, which exceeds \$3,000 or any collection of articles which value more than \$10,000 have to be appraised.

I recommend that the fiduciary obtain a copy of the decedent's homeowner's policy and floater covering itemized personal property to identify times of significant value.

If the decedent was the beneficiary of a qualified terminable interest property trust (QTIP trust) the value of that trust is reported on this schedule.

Schedule G – Transfers During Decedent's Life.

After answering "yes" to the questions of Part 4, lines 11 and 12(a), the fiduciary has to report these assets in this schedule. This is where the value of trusts and certain transfer will be reported including the gifts in which the decedent retained control of beneficial enjoyment or gave up control or enjoyment within three years of death. This schedule is the one of the most challenging schedule to complete.

- a) *Gifts Made Within Three Years of Death.* All federal gift taxes paid by the decedent on gifts made within three years of the decedent's death shall be included in the decedent's gross estate⁸.
- b) *Other Transfers Within Three Years of Death.* The following transfers⁹ are included in the gross estate of the decedent: (1) transfers of any life insurance policy on the life of the decedent, and (2) transfers of retained interests or powers that would have been included in the gross estate had the decedent continued to hold the interests or powers until death.
- c) *Transfers With Retained Life Estate.* When the decedent retains a life estate in a property, the full value of the property shall be included in the

⁷ See I.R.C. Section 2040.

⁸ See I.R.C. Section 2035(c).

⁹ See I.R.C. Sections 2035(a) & 2035(d)(2).

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gross estate and be reported on this schedule. Life estate¹⁰ includes the right to enjoy, the right to designate the persons who would possess, or enjoy the transferred property. This includes the transfer of real estate properties but also the transfer of stock in a controlled corporation when the decedent retained the right to vote. Transfer to minors may be included if the decedent either designated him/herself as custodian or become successor custodian by statute.

d) *Transfers Taking Effect at Decedent's Death.*

Under Section 2037 of the I.R.C., when the enjoyment of the property by the recipient is delayed until the decedent-transferor's death, the full value of the property shall be included in the gross estate. In addition, properties in which the decedent retained a reversionary interest worth at least five-percent of the property shall be included in the gross estate. The value of the property to be reported shall be its value immediately before the decedent's death.

e) *Revocable Transfers.* Revocable trust created by the decedent, in which the decedent retained the right to alter, amend, revoke, or terminate shall be included in the gross estate and reported in this schedule. Even if the decedent relinquished any of the powers covered by this schedule, the trust will be included in the gross

estate when the relinquishment occurred within three years of death.

Additions and improvement of the property shall not be included in the gross estate. This is very important for life insurance. For instance, if the decedent dies within three years of the transfer of an insurance policy and the transferee has made any premium payments after the transfer, a portion of the death benefit is excluded. This exclusion is determined by multiplying the death benefit by the percentage of the premiums paid by the transferee compared to the total premiums paid on the policy¹¹.

You must attach a copy of the instrument. If the instrument is public record, the copy shall be certified, of not, then the copy should be verified.

Schedule H – Powers of Appointment. A power of appointment determines who will own or enjoy the property, and when this enjoyment starts. The power to be reported in this schedule is not created by the decedent but by another person. For instance, John, settlor of a trust transfers property to Mary, his wife, for her life with a power in Mary to appropriate or consume the principal of the trust. Mary has a power of appointment. The following powers are not power of appointment: power to

¹⁰ See I.R.C. Section 2036.

¹¹ See *Estate of Silverman v. Commissioner*, 61 T.C.338(1973), *aff'd*, 521 F.2d 574(2d Cir. 1975); Priv. Ltr. Rul. 87-24-014 (Mar. 11,1987).

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amend administrative provisions, power to manage, invest, or control assets, or to allocate receipts and disbursements.

The power of appointment is a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate. In addition, a part of a power is considered a general power of appointment if the power: (1) may only be exercised by the decedent in conjunction with another person, and (2) is also exercisable in favor of the other person (in addition to being exercisable in favor of the decedent, the decedent's creditors, the decedent's estate, or the creditors of the decedent's estate).

So, in this schedule, the fiduciary will report the value of property for which the decedent:

- ◆ possessed a general power of appointment on this date of the death, and
- ◆ exercised or released before death by disposing of it in such a way that if it were a transfer of property owned by the decedent, the property would be includible in the decedent gross estate as a transfer with a retained life estate, a transfer taking effect at death, or a revocable transfer.

Therefore, if the decedent has release a complete his/her power, the power of appointment is not included in the gross estate.

If the decedent ever possessed a power of appointment, you must attach to the return a certified copy of the instrument granting the power. It does not matter whether the power was exercised or released or whether the property is not included in the gross estate.

Schedule I – Annuities. All annuities in which the decedent had an interest shall be reported on this schedule. The fiduciary will also have to answer “yes” in questions 15 of Part 4.

A term annuity includes one or more payments extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic. The annuity will be included in the gross estate if the decedent was in fact receiving an annuity or other payment with or without an enforceable right to have the payments continued.

When the decedent only contributed a part of the purchase price of the contract or agreement, the fiduciary should report only this part on the schedule.

Certain annuity may be excluded from the gross estate. The rules of annuities under plan approved have been repealed but may still apply for decedent who retired before January 1, 2085.

Schedule J – Funeral and Administrative Expenses. Funeral expenses include reasonable expenditures for a tombstone, monument or

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mausoleum, burial lot for the decedent or the decedent's family (including reasonable expenditure for future care of the lot), and cost of the transportation of the body and a person bringing the body to the place of burial. Reasonable expenses are related to the wealth and standard of living of the decedent.

Administrative expenses can be allocated in anyway the fiduciary chooses between the Form 706 and the estate's income tax return. However, double deductions are not allowed. There are separate line to report the executor's commission, attorney fees and accountant fees under administrative expenses. The IRS will review these deductions carefully particularly the executor's commission and will take into consideration the state standards for calculating the executor's commission.

Schedule K - Debts, Mortgages, and Liens. All legally enforceable debts of the decedent are reported on this schedule, which is divided in two parts. On part 1, the fiduciary will report the decedent's debts including the decedent's income tax liability accrued as of the date of death, and obligations to a former spouse. On part 2, the fiduciary will report mortgages for which the decedent is personally liable, and contingent liabilities.

If the fiduciary has difficulties calculating the allowable death taxes reported on part 1, he/she can

request a computation of it to the IRS. The request should be sent within a reasonable time before the due date of the return to the Department of Treasury, Commissioner of Internal Revenue, Washington, DC 20224.

Schedule L - Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims. Casualty losses that occur during the settlement of the estate are reported on this schedule. For instance, losses from: thefts, fires, storms, or shipwrecks.

Schedule M – Bequests, etc. to Surviving Spouse (Marital Deduction). Property interests passing to a surviving spouse who is a US citizen may qualify to the marital deduction under I.R.C. Section 2056. For a non-US citizen spouse to elect the marital deduction, the property received should be held in a Qualified Domestic Trust (QDT). The fiduciary may elect the deduction for a Qualified Terminable Interest Property Trust (QTIP trust) either for the entire value of the trust or for a portion of it. The portion not reported on schedule M, should be included in the gross estate.

The funding of the marital deduction should be carefully reviewed. Audits often question the marital deduction particularly regarding the computation of the marital deduction amount for residual estate property passing to the spouse if the

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residual estate is subject to taxes and administrative expenses.

Schedule O – Charitable Deduction. The fiduciary will report on this schedule all interests that qualify for charitable deductions under I.R.C. Section 2066, including outright transfers to charitable organizations, qualified split interest charitable remainder trusts, property passing to charities by court decree, and qualified conservation easements. An outstanding charitable pledge by the decedent, if legally enforceable, constitutes an obligation reportable on schedule K not on schedule O. There is no limit on the amount of charitable deductions.

Schedule P – Credit for Foreign Death Tax. When the decedent owned property oversea, the fiduciary will have to review international tax treaty and consult will local counsel. If the decedent was a non-resident U.S. citizen, the fiduciary must attach the following documents: (1) a copy of the inventory of property and the schedule of liabilities claims against the estate, and expenses of administration filed with the foreign court of probate jurisdiction; (2) a copy of the return filed under the foreign inheritance, estate legacy, succession tax, or other death tax act, certified by a property official of the foreign tax department.

Schedule Q - Credit for Tax on Prior Transfers. In order to avoid double taxation, the IRS allows a

credit for tax when the transferee received property from a transferor who died within 10 years before, or died 2 years after the transferee.

Schedule R and R-1 – Generation-Skipping Transfer Tax. This tax will be discussed in Paragraph C.

Schedule U – Qualified Conservation Easement Exclusion. Created under the Taxpayer Relief Act of 1997, the fiduciary may elect to exclude a portion of the value of land that is subject to a qualified conservation easement. Land may qualify for the exclusion if all of the following requirements are met:

- ◆ The decedent or a member of the decedent’s family must have owned the land for the 3-year period ending on the date of the decedent’s death.
- ◆ No later than the date the election is made, a qualified conservation easement on the land has been made by the decedent, a member of the family, the executor, or trustee.
- ◆ The land is located in the United States or one of its possessions.

The “conservation purpose” means:

- (1) the preservation of land areas for outdoor recreation by, or the education of, the public;

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- (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; or
- (3) the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or under a clearly delineated federal, state, or local conservation policy and will yield a significant public benefit.

A maximum exclusion amount of \$500,000 may be allowed.

Payment of Tax and Fiduciary Liability. The Form 706 shall be filed with the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999. The check is payable to the “United States Treasury.” You should write on the check the decedent’s name, social security number, and “Form 706.”

Please note that on line 4 of Part 2, the fiduciary will have to report all of the taxable gifts made during the life of the decedent. The portion of the \$1 million gift tax exclusion, which has been used during the life of the decedent, will reduce the estate exclusion amount. Actually, the gifts made are included in the gross estate and the gifts tax paid are deducted on line 4.

The IRS will send a closing letter approximately 9 months after the filing of the Form 706.

There is no personal liability of the fiduciary unless the fiduciary pays in whole or in part any debt due by the estate before satisfying the estate tax due to the United State.