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Report 10

Thursday, January 8

2:00 - 5:15 p.m. FUNDAMENTALS PROGRAM
Preparing and Filing the Form 706: Who, What, How, When and Where
Glen A. Yale

Reporter: Jason Havens Esq.

REPORTER'S SUMMARY: This was an excellent presentation on preparing and filing the federal estate tax return, even for those who have prepared returns for many years. Glen was both entertaining and informative. His excellent outline guides you through the crucial preliminary steps and then through each part of the actual IRS Form 706. He pointed out several nuances of each schedule and the proper way to report common and uncommon property items. His materials also include several useful checklists, client letters, client memoranda, and a sample estate tax return.

REPORTER'S COMMENTS: References with only numerals are generally IRC citations. "GE" refers to "gross estate." "DOD" refers to "date of death." "FMV" refers to "fair market value." "IRD" refers to "income in respect of a decedent."

SECTION 1: GENERAL MATTERS:

1.03: Executor files 706 under penalty of perjury.

Preparer: Treas. Circular 230

1.04: Preparer/Client Relationship: Same for attorney or CPA. See *Bria v. U.S.* (D. Conn. 2002) (attorney representing executor and withdrawal; subpoena for attorney's records; standard to assert privilege; held that communications and NOT underlying facts covered). Therefore, PUT NOTHING IN FILE that do not want IRS to see.

Engagement letter: CHECKLIST. Identify client, confidentiality defined, scope of engagement (and maybe what is BEYOND scope, e.g., exclude opinion on documents used to prepare 706 such as other tax returns -- see ACTEC COMMENTARIES, which are available via Internet), financial terms, termination, and required disclosures.

Time table for preparing and filing 706: Key to prepare good draft 706 by 8 months after date of death because MIGHT NEED DISCLAIMERS (and might need to obtain court approval).

File ownership: Executor by default but may be changed by engagement

1.05: Filing threshold: Adjusted taxable gifts + specific exemption for post-9/8/1976 gifts + gross estate on DOD. Disregard: deductions, alternate valuation, special use valuation, and QFOBI.

1.06: Obtaining information: Checklist: income tax returns, checks/registers, balance sheets (see

Trompeter v. Comm., T.C. Memo. 1998-35), insurance policies, decedent's mail, previous estate tax returns (e.g., for SS or child), decedent's will, decedent's employer.

1.08: Where filed: Hand-delivered or mailed or private delivery service to Cincinnati (no electronic filing due to attachments); non-residents must file in Philadelphia.

1.09: Date of death: Refer to death certificate (or process to correct); time and date controls based on decedent's DOMICILE TIME ZONE (even if dies in another time zone), but foreign death is time zone where decedent actually dies. If presumptive death (e.g., 9/11/2001), IRS says 7 years of absence (PLR 8526007), but conflicts with some state laws (e.g., TX is based on court decree of death).

1.10: Responsibility for payment: Executor not responsible UNLESS distributions made and knowledge of insufficient estate assets. US v. First Midwest Bank/Ill., N.A., 1997 WL 675192 *13 (N.D. Ill. 1997).

1.11: Deadline: 9 months after DOD (same as disclaimers) but extension of six months. If late, lose 6166 extended payout and penalties but only election lost.

1.12: Extensions: Automatic 6 months (Form 4768) and no more unless regulatory extension (e.g., in Iraq). Extension to PAY generally allowed. See Treas. Reg. 20.6161-1. Longer-term payout available, e.g., for closely-held business (6166) or future reversion/remainder (6163), BUT bond required (sometimes twice value of estate tax) and difficult to obtain sometimes.

1.14: Penalties:

Undervaluation (6662(e)(2)) but avoided if substantial authority for tax treatment, disclosure of relevant facts, or reasonable reliance on appraisal (see, e.g., *Sammons v. Comm.*, 838 F.2d 330 (9th Cir. 1988)).

Civil Fraud: 6663: 75% of underpaid tax. See *Trompeter v. Comm.*, No. 99-70805 (9th Cir. 2002).

Criminal Fraud: 7201

1.15: Estate tax liens: 6324 (10 years)

1.16: Deficiencies: 6501 (generally three-year rule but exceptions for false/fraudulent return (no time limit), omissions (six-year period *but see Estate of Helen G. Williamson v. Comm.*, 72 TCM (CCH) 687 (1996)). Can obtain discharge from personal liability via 2204 (no increase re: audit probabilities or anything else).

1.17: Amending Return: No such thing, but "supplemental information" allowed. See Treas. Reg. 20.6081-1(d). Does NOT cure fraud. See *Badaracco v. Comm.*, 464 U.S. 386, 294 (1984). If audit, must disclose assets omitted in good faith; if no audit, NO NEED to disclose omitted assets if good faith. Claim for refund: 6511(a): Must be filed within 3 years of original 706 and prior to any court action. See Zeier v. US, 80 F.3d 1360, 1363-64 (9th Cir. 1996) (what NOT to do).

SECTION 2: VALUATION:

2.02: Defined: Treas. Reg. 20.2031-1(b): Hypothetical willing buyer-willing seller. Q of fact.

2.03: Date: Estate of *McClachey v. Comm.*, 147 F.3d 1089, 1091 (9th Cir. 1998).

2.04: Alternate valuation: 2032 (6 months)

2.05: Valuation and basis: 1014(a): FMV @ DOD unless IRD (691).

2.06: Valuation Discounts: Lack of marketability, FLPs, key-person, time-value of money

SECTION 3: REQUIRED INFORMATION:

3.08: Disclaimers: 2518: Refusal to accept transfer.

Required questions: gift tax returns (Q 7 -- reasonable inquiry re: unreported gifts)

SECTION 4: SCHEDULE A -- REAL ESTATE:

4.01: When completed: Generally only probate real property.

4.04: Required information: Describe with enough detail that IRS can locate. *See* Treas. Reg. 20.6018-3(a).

4.05: Valuation: Property tax value acceptable if FMV. See 20.2031-1(b). Can use appraisal or sale close to DOD. Appraiser engagement letter checklist (6.07(D)(3)). Appraisal report review checklist (4.05(C)(5)). Discounts (fractional interest, market absorption, catastrophic events).

4.07: Mortgages: Reported on Schedule K unless non-recourse (and then report net figure on Schedule A).

4.10: Alternate valuation: Rent prior to DOD included. Mineral production post-DOD included. Should UPDATE appraisals from DOD to AVD (include in engagement letter).

4.11: Attachments: Appraisals, ad valorem tax appraisal, and/or closing statement (if value based on sale).

SECTION 6: SCHEDULE B -- STOCKS/BONDS:

6.01: When completed: When GE includes ANY stocks or bonds

Three categories: closely held, publicly traded, or blocks of publicly traded.

6.03: Stocks: *See* 706 Instructions p. 12; Treas. Reg. 20.6018-3(c)(2). Dividends listed separately.

6.04: Bonds:

6.06: Valuation: 706 Instructions p. 13; Treas. Reg. 20.2031-2. Recommendation to use valuation services.

6.07: Closely held stock: Obtain appraisal. See Rev. Rul. 59-60.

6.15: Attachments: quotations, discount support, appraisals, more information for closely held stock.

SECTION 7: SCHEDULE C -- MORTGAGES/NOTES/CASH:

7.01: When completed: Self-explanatory.

7.02: How reported: Order to list items.

7.03: Mortgages: Valuation: *See* Treas. Reg. 20-2031-4. SCINs: S*ee Estate of Musgrove v. US*, 95-2 USTC para. 60,204 (Fed. Cl. 1995). Below-market loans: 7872.

7.05: Cash in possession: Cash on hand.

7.06: Cash in banks: *See* Treas. Reg. 20.6018-3(c)(3).

7.08: Attachments: Appraisals, copies of notes reported at less than remaining balance, but NOT bank statements (just indication that reviewed by preparer).

SECTION 8: SCHEDULE D -- INSURANCE ON DECEDENT'S LIFE:

8.01: Reporting life insurance: All insurance, even if not included in GE (explain if not includible). Obtain Form 712 from insurance companies; provides value.

8.02: Inclusion in GE: 2042

8.03: Policy held by corporation: Only included in valuing corporation and decedent's stock in corporation IF proceeds payable to corporation. If proceeds NOT payable to corporation and attributable to decedent (more than 50% of stock), then includible.
8.06: Insurance otherwise included: Listed on Schedule D, but reported on Schedule G (2035-38).

8.08: ILITs: List by describing trust and note no incidents of ownership held.

SECTION 9: SCHEDULE E JOINTLY-OWNED PROPERTY:

9.01: When completed: Joint tenancies WROS and tenancies by the entirety. Listed EVEN IF not includible in GE.

9.02: Qualified joint interests:

9.05: Disclaimer of joint interests: See Treas. Reg. 25-2518-1 & -2.

SECTION 10: SCHEDULE F -- OTHER MISC. PROPERTY:

10.01: When completed: Must answer three questions EVEN IF no property needs to be listed. Appraisals might be required.

10.02: Property reported: Checklist: Automobiles (http://www.kbb.com), coin collectibles (see

Trompeter v. Comm., T.C. Memo. 1998-35), contraband (see TAM 9207004 (amazing!)); *Sammons v. Comm*., 838 F.2d 330 (9th Cir. 1988); Paul Adams, 50 TCM (CCH) 48 (1985)), personal effects (list required: Treas. Reg. 20.2031-6(a)), jewelry (get AUCTION HOUSE appraisal because approved by IRS), lawsuit (see Estate of Smith v. Comm.)

Marital/2044 property and duty of consistency required (*see Estate of Letts v. Comm*., 190 TC 290 (1997)) but certain QTIP property not included if QTIP not required to reduce prior estate to zero (see Rev. Proc. 2001-38).

SECTION 11: SCHEDULE G -- TRANSFERS DURING DECEDENT'S LIFE:

Custodian on UTMA/UGMA account: Includible because allowed to discharge debt of decedent.

[SECTIONS 12, SCHEDULE H, through 23, SCHEDULE U, not discussed due to lack of time.]

2:00 - 3:30 p.m. Special Sessions III

Reporter: Carol Warnick Esq.

III-D The Uniform Trust Code: Your State Might Be Next
Prof. David M. English
Judith W. McCue
Scot W. Bouton

The Uniform Trust Code has been enacted to date in five states, Kansas, Arizona, Nebraska, New Mexico, and Wyoming. It is under consideration or study in over 30 other states.

Most American trust law developed prior to 1900. The world we live in is so different now. Two examples, (1) at that time there was no federal tax system and (2) marriages may not have been happy but they lasted longer. Trust are much more common now, yet trust law in many states is very thin. While much of the UTC codifies the common law, it does make some significant changes.

Remember, for the most part, the UTC contains default provisions which can be drafted around. When asked why not leave everything up to the draftsman, the reply was that because of the increased use of trusts, many trusts are being drafted by planners who do not really understand the law or the issues involved, or maybe even come out of a book or a trust kit. The feeling is that some protection should be provided by enacting these basic laws.

The most controversial issue that has come up so far has been the notice and reporting requirements to beneficiaries. Section 813 of the UTC fills out and adds detail to the trustee's duty to keep the beneficiaries informed of administration. When in doubt, the UTC favors disclosure to beneficiaries as being the better policy.

Section 103(12) defines a "qualified beneficiary" as a beneficiary who, on the date the beneficiary qualification is determined, (A) is a distributee or permissible distributee of trust income or principal; (B) would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in subparagraph (A) terminated on that date; or (C) would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date. This definition essentially includes the remainder beneficiaries but leaves out alternative and contingent remaindermen.

Public policy issues permeated the notice discussions. Grantors generally expect to have more control in a trust environment than if their will was being probated, and many Grantors do not want the beneficiaries alerted to the trust until absolutely necessary. This must be balanced with the rights of the beneficiary to protect themselves. States are using a variety of approaches when they adopt the UTC. .

Article 3 deals with representation, and many feel this is the most valuable part of the UTC. It provides comprehensively for the representation of beneficiaries and others unable to represent themselves, both with respect to notices and consents, and without judicial intervention. Virtual representation (of minors, unborn beneficiaries, etc. is allowed.)

Modification and termination of trust provisions were discussed. Due to increasing use of long-term trusts, there is a need for greater flexibility in the rules about when a trust may be modified or terminated. Must also remember that the primary objective of trust law is to carry out the settlor's intent.

The beneficiaries and the settlor can get together and terminate a trust. This is a codification of well-settled common law. However, remember, the 643 final regs do not bless the termination of a trust. Also a potential Strangi issue. under 2036(a)(2). Section 411 of the UTC allows for the settlor and the beneficiaries to modify or terminate a trust. Is this a taxable power? 2038 regs say that if a power is based on state law it is not a taxable power under 2038. The 2036 regs do not say that. If the settlor participates in the modification or termination of a trust then are all irrevocable trust taxable a la Strangi?

One major change is to do away with the presumption that a spendthrift provision is a material purpose barring the beneficiaries from compelling termination of a trust. Used to be that a spendthrift clause was not in a trust unless it was a material purpose of the trust. Now they are almost boilerplate. (Spendthrift provisions did not originate in England like most of our trust law. They originated in Massachusetts.)

UTC also allows for termination of an uneconomic trust (a value of $50,000 or less) without a court order or any other special procedure.

3:45 - 5:15 p.m. Special Sessions IV

Reporter: Carol Warnick Esq.

IV-B Formulas, Fractions and Ratios - Oh My!
S. Stacy eastland
A Christopher Sega

Stacy Eastland began the presentation talking about the McCord case. He discussed his thinking in setting up the transaction and what he thinks can be gleaned from the case.

Possible "Bad News" from *McCord*:

1. Transactions with charities are not considered transactions with unrelated adverse parties for a

majority of the court.

2. This case is precedent for the proposition that a transferor may have to pay gift taxes based on a transaction over which the transferor had no control. (The kids negotiations with the charities to buy out the charities' interests.)

3. There appears to be an implication that defined formula clauses will only be recognized if the major words "as finally determined for Federal gift tax purposes" are included somewhere in the formula clause. (This would not be practical in commercial transactions between nonrelated parties.)

4. If a future Tax Court adopts the reasoning of the concurring opinion of Judge Swift, no charitable deduction would be allowed for any gifts of partnership interest to charities, unless under (i) the assignment documents, (ii) the partnership agreement, or (iii) the applicable state property law that charity is immediately admitted to the partnership as a full-fledged member.

Possible "Good News" from *McCord*:

1. If the assignment document provides that the donee is an assignee, and other surrounding facts are consistent with the assignment document, the Tax Court will recognize that what a hypothetical willing buyer will pay for the transferred interest is only based on assignee rights That recognition by the Court may have a profound effect on the amount of the marketability discount that is allowed.

2. It appears that all but two judges of the current Court will find a defined value formula clause is not against public policy when it involves a charity and will even allow a charitable deduction that may be substantially above what the charity actually receives. A majority of the Court allowed the donors a charitable deduction that was approximately 28% above that the charities ultimately received.

3. The case strongly suggest that a majority of the Court would be prepared to allow pecuniary defined value formula clauses, which incorporated the phrase "as finally determined for federal gift tax purposes." This seems especially so where the value as finally determined will be divided among the donees and be retained by them in the proportions provided by the formula, with no "buyout" by one donee of another prior to final valuation For instance, defined value formula clauses incorporating that phrase in which the excess value over a stated dollar amount goes to a grantor retained annuity trust, or to a marital deduction trust, appear to have the support of all but two of the judges on the Tax Court.

They discussed a possible technique where the next tier donee is a limited power of appointment trust. You can use the same trust that receives the first tier gift (a single trust with 2 sub-trusts - one trust representing the gift element over which you retained a limited power of appointment, and the other trust where the gift would be complete.) Make both trusts grantor trusts so if ever there is a change in the income interest, the grantor still pays the tax. If there are adjustments, no amended income tax returns will have to be filed. If the property is sold, the sale proceeds can be allocated between the two sub-trusts and adjustments made later if necessary.

Sega: He liked the fact that in McCord. Stacy used the donor advised fund of the community foundation...He asked Stacy if he thought that the fact it was a donor advised fund had anything to do with the decision in *McCord*? Stacy said he thinks that what made the court mad was the lack of an independent appraisal (even though they were instructed to obtain one, but chose not to.)

Stacy Eastland discussed another type of transaction discussed on page 19 of his special session materials, using a formula defined value clause so the gift element can go into a transaction where you minimize the taxable gift, such as a GRAT.

He briefly discussed GRATs in comparison with sales to defective trusts. GRATs have advantages in that there is a built in revaluation clause. GRATs have the disadvantage that you can die early before the term of the GRAT is up. You can do cascading GRATs to deal with that risk. The problem still remains that interest rates can go up. (His aside was that you never know when Jimmy Carter may be re-elected.)

The advantage to sales to defective trusts is that you can lock in today's low interest rates.

Example 4 in his materials uses a formula amount, a note coming back, the words "as finally determined for federal gift tax purposes", and if the value exceeds the dollar amount, the excess goes to a GRAT. Hopefully, the worst that can happen is that the donor does not end up selling as much to the kids as he had hoped.

Think of this in terms of the *Strangi* problem. If you are looking for an exit strategy, one might be to do this type of transaction, or do a redemption, and to the extent the value exceeds your dollar amount, the excess goes to the GRAT.

Example 5 places the whole partnership interest into a GRAT followed by a formula defined value transfer of the retained annuity in the GRAT to an Intentionally Defective Grantor Trust. Stacy said it was hard to see how you can get in trouble with this on a short term GRAT.

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