FEDERAL ESTATE TAXES – A PRIMER

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STATE BAR OF NEW MEXICO
TAX CONSIDERATIONS IN ESTATE PLANNING COURSE
APRIL 27-28, 2011
ALBUQUERQUE, NEW MEXICO

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THE FEDERAL ESTATE TAX – A PRIMER

I. INTRODUCTION

The focus of this paper is to provide an introduction to the federal estate tax and the preparation of the United States Form 706 Estate (and Generation-Skipping Transfer) Tax Return ("Form 706"). Unfortunately, the topic is broad and no single paper can really do the topic justice. Volumes have been written to address the tax and its numerous and particular nuances. The author encourages the reader to consult other sources for focused treatment of detailed issues that might face them. RIA and BNA are leading publishers of such materials. The author finds BNA's Tax Management Portfolios particularly helpful to serve as a starting point for research into most issues surrounding the federal transfer taxes.

Excluded from the scope of the paper are the federal gift and federal generation-skipping transfer taxes, both of which potentially have an impact on the preparation of a large number of Forms 706. Other speakers will address these taxes.

The author and Ruth Ann Castellano-Piatt, a very competent CPA from Albuquerque, were asked to share this topic. Accordingly, they have divided the work and this paper will address only certain portions of preparing the Form 706. The division of labor may seem to have been haphazard, but rest assured, there was some rationale behind the division (mostly to serve the two authors). Please see the Table of Contents of this paper for the issues addressed herein.

The paper will typically speak in terms of the estate and executor. The author is well aware that New Mexico has no such thing as an executor. Regardless, and consistent with federal law usage and out of a concern for saving key strokes, the term "executor" will be substituted for "personal representative".

II. THE FEDERAL ESTATE TAX

A. Introduction

For lawyers and others new to the federal estate tax, the tax's legal structure may come as a surprise. For example and despite popular usage, the federal estate tax is neither a "death tax" nor an "inheritance tax". Rather, the federal estate tax is an excise tax on the right of a decedent to transfer his or her property upon death. *See* 26 U.S.C. (hereafter "Code") § 2001(a) (the tax is imposed "on the transfer" of property). Also contrary to popular opinion, the estate tax is not necessarily a rich person's tax. Technically speaking, the tax is structured in a manner that every solvent estate of any deceased U.S. citizen or resident is subject to the federal estate tax, regardless of value. *Id*. Under the current estate tax rate schedules, for example, the estate tax for an estate with a fair market value of only $10,000 is $1,800. *Id*. § 2001(c). The only reasons the estate tax is not of practical effect for most people are that (i) the law also provides a credit against the tax, which effectively exempts the vast majority of estates from the estate tax; and (ii) an estate has a duty to file a Form 706 only if its fair market value would result in a tax due after application of the credit. *See id*. §§ 2010(b) (providing for the unified credit), 6018(a) (stating duty to file a return).

For sake of reading clarity, the paper will speak of the unified credit in terms of its applicable exemption amount. For example, and under the current tax tables found at Code § 2001(c), estates valued at $5,000,000 would be subject to a tax equal to $1,730,800. Code § 2010, in turn, provides all estates with a credit equal to the tax that would be incurred for a $5,000,000 estate or $1,730,800. Code § 2010(c). The credit against the estate tax of up to $1,730,800, effectively exempts estates valued equal to or less than $5,000,000 from taxation. The applicable exemption amount (hereafter "exemption") is therefore $5,000,000.

Non-resident aliens and expatriates also do not escape the tax. *See* Code §§ 2101 (non-resident aliens), 2107 (expatriates). Certain inheritances received by U.S. citizens or residents from former long term residents also are subject to taxation. *See id*. § 2801. Generally speaking, the estate of a non-resident alien with an estate, which is both situated in the U.S. and valued in excess of $60,000, must file a return (Form 706-NA). A further discussion of estate taxation with an international flavor is beyond the scope of this paper. The author has presented two recent papers (dated 2009 and 2010, respectively) to the State Bar of Texas, which he would be happy to make available upon request.

B. The Tax Relief Act of 2010

The year 2010 was a year of much uncertainty about the estate tax. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the estate tax was repealed for persons who died in 2010, and the estate tax was set to come back with a vengeance in 2011, providing only the equivalent of a $1,000,000 exemption from the estate tax. Yet, on December 17, 2010, Congress finally enacted the Tax Relief Act of 2010 (the "Act"). The Act reenacted the estate tax for 2010, but increased the exemption to a historically high level of $5,000,000. Beginning in 2012, the exemption also will be indexed for inflation. Unfortunately, the Act really should be known as the "Kick it Down the Road Act of 2010" because it sunsets on December 31, 2012, less than two years from now. The result is continued uncertainty for estate planning.

The Act also adds another complication for estates of decedents who died during 2010. Recognizing the fundamental unfairness of imposing a tax upon a transfer of assets that took place in the past (with

respect to estates valued in excess of $5,000,000), the Act also provides an election out of the estate tax. Act § 301(c). The cost of such an election is that the estate will be subject to the modified carry over basis regime of Code § 1022 (limiting the step up in basis for capital gains purposes at death to an aggregate $1,300,000 plus an additional $3,000,000 for transfers to surviving spouses). At first blush, it seems that only estates valued greater than $5,000,000 would even consider making the election out of the estate tax. The author has found, however, that the election also makes sense for very modest estates if the decedent was the beneficiary of a qualified domestic trust under Code § 2056A.

The election out of the estate tax during 2010 and the reporting of the aggregate basis increase under Code § 6018, which will be reported on Form 8939, is beyond the scope of this paper. As of the date this paper was written (mid-April 2011), the IRS had not yet published a final form or instructions. The only guidance provided by the IRS is that the Form 8939 will not be due until the ninetieth day after the final form is published.

For an excellent general discussion of the Act and its impact on estates, please see the McGuireWoods white paper entitled "The 2010 Tax Act's Impact on Estate Planning and Administration", January 2011, available at www.mcguirewoods.com.

C. General Discussion of the Estate Tax

A quick review of page 1 of Form 706 reveals the correct manner in which the estate tax is calculated.[1] Currently, each estate has a $5,000,000 exemption against the value of the gross estate. To calculate liability, however, the estate must add the value of past taxable gifts. The effect of adding the past gifts is to lower the exemption that is available for use against the gross estate's value at death. Depending on whether the decedent made taxable gifts during life, a person's remaining available exemption amount may be significantly less than $5,000,000. Deductions and possible credits other than the unified credit also should be taken into account.

The general steps to calculate estate tax liability are as follows:

- Determine the decedent's total gross estate;
- Determine allowable deductions (*e.g.*, marital deduction, charitable deductions and deductions for administration expenses);
- Determine the state death tax deduction, if any;
- Determine the "Taxable Estate" by reducing the gross estate by the deductions;
- Add taxable gifts made by the decedent;
- Determine the tentative tax based on the sum of the Taxable Estate plus taxable gifts using the tax tables;
- Add gift taxes paid within 3 years of life;
- Determine the gross estate tax by adding the tentative tax and the includable gift taxes;
- Reduce the gross estate tax by the unified credit;
- Reduce that amount by any credit for foreign death taxes and for taxes paid on prior transfers;
- The result is the net estate tax due.[2]

A simple example illustrates the proper calculation. Assume the decedent who died in 2010 had a gross estate worth $6,000,000 and had made no lifetime taxable gifts. She also was the beneficiary of a QTIP trust established by her husband at his death with a value of $3,000,000. Her will gave $2,000,000 to charity and the rest went outright to her three children in equal shares. The decedent's daughter was a top notch estate planning attorney, who administered the estate for free. Funeral expenses, however, were $50,000. The estate taxes, in this example, are calculated as follows:

Gross estate	9,000,000
Less Deductions (charitable and administration expenses)	(2,050,000)
Taxable Estate	6,950,000
Tentative Tax – current tax table	2,413,300
Gross estate tax	2,413,300
Unified credit	1,730,800
Net tax due	682,500

Many of the terms used in Form 706 have significant and technical meanings. Those meanings will be discussed in detail, below.

[1] A copy of the 2010 Form 706 and the IRS's instructions for the form can be obtained from the IRS website. As of the time this paper was written (mid-April 2011), the available Form 706 was to be used for deaths in 2009, only, and the IRS had not yet published the Form 706 for deaths that occurred in 2010. Pursuant to the Act, the Form 706 for 2010 deaths and associated estate taxes will not be due until September 19, 2011 or nine months after the date of death, whichever is later. Act § 301(d). Note that some instructions are found as part of the Form 706, itself. Accordingly, one should consult both the form and the instructions when completing the return.

[2] The steps completely ignore possible generation-skipping transfer tax liability, which is beyond the scope of this paper.

III. THE ESTATE TAX RETURN – FORM 706

A. General Concerns

The executor of the estate is charged with personal liability to pay the estate tax, if any is due. Code § 2002. The executor also is charged with the duty to file the estate tax return if one is due. *Id*. § 6018(a)(1). The term "executor" is defined as the executor or administrator of the estate. Code §§ 2203, 7701(a)(47) (containing substantially the same definitions). Note that a New Mexico decedent might never have an executor or administrator. Under New Mexico law, a person nominated as a personal representative in the will of a decedent does not have any power as personal representative until a court has appointed the person. NMSA § 45-3-701(A). Especially when the decedent has engaged in planning using a revocable trust, a personal representative may never be appointed by a court. Nevertheless, the Code also imposes the same duties on the persons "in actual or constructive possession" of the decedent's property. Code §§ 2203, 7701(a)(47). Accordingly, it behooves the executor, whether appointed or not, and the successor trustee, and any other person in possession of the property of an estate that might be taxable to take care to secure the property against payment of the tax.

The executor must file a Form 706 only when the gross estate exceeds the exemption amount in effect under section 2010(c). Code § 6018(a)(1). Note that the trigger for a Form 706 is the gross estate's value, not the net estate after deductions are applied. *Id*. As a result, it is necessary to file a Form 706 simply to claim a deduction that would otherwise make the estate non-taxable. Further, if the decedent made taxable gifts, the exemption amount is reduced by the value of the gifts to determine whether the gross estate exceeds the amount triggering a duty to file a return. *Id*. § 6018(a)(3). If beneficiaries of certain portions of the gross estate (like recipients of life insurance proceeds) do not cooperate with the executor, the executor may file a statement with the IRS, which then may force the beneficiaries also to file a return. *Id*. § 6018(b).

Generally speaking, the Form 706 is due nine months after the date of the decedent's death. Code § 6075(a). However, for deaths from January 1, 2010 through December 17, 2010, inclusive, the effective date of the Tax Relief Act of 2010 (the "Act"), the return is due no earlier than September 19, 2011. Act § 301(d). An automatic one-time, six month extension also is available for making the return, upon filing Form 4768 on or before the original due date. Regs. § 20.6081-1(b).

Under most circumstances, the estate tax, if due, also must be paid within nine months of the date of death. Code § 6151(a); Regs. § 20.6151-1. Again, for deaths from January 1, 2010 through December 17, 2010, inclusive, the due date for the tax to be paid is September 19, 2011. Act § 301(d).

Otherwise, there are a handful of provisions that allow for extensions to pay the tax. Under Code § 6161(a)(1), for example, the IRS may extend payment of the tax for a reasonable time up to 12 months, upon reasonable cause shown. Reasonable cause typically is related to a liquidity crisis. *See* Regs. § 20.6161-1(a)(1). In undue hardship situations, the IRS may extend the time for payment up to 10 years. Code § 6161(a)(2). In the latter situation, however, "undue hardship" only exists when one or more significant illiquid assets comprise the bulk of the estate. Regs. § 20.6161-1(a)(2). In both situations, interest will apply. Requests for extensions under section 6161 also are made on Form 4768.

When the gross estate includes a reversionary interest (*see* Code § 2037) the estate may seek an extension of time to pay the tax associated with the reversionary interest for a period of six months following termination of the preceding interest. Code § 6163. This election is made on the Form 706 and by also sending a letter to the Cincinnati Submission Processing Center together with a certified copy of the instrument creating the reversionary interest. *See* Regs. § 20.6163-1(b); Form 706, Part 3, Question 3.

Estates which include closely-held business interests also are eligible for an extension of time to pay the tax due under certain circumstances. *See* Code § 6166. The very complicated provisions and tests for determining qualification for the section 6166 extension are found both in the statute and in the Regulations at section 20.6166-1. The details are quite detailed and very much beyond the scope of this paper. Again, the election for deferral of payment under Code § 6166 is made on the Form 706. *See* Form 706, Part 3, Question 3. The IRS may require the executor to provide security in the form of a surety bond or a lien against the property under Code § 6324A. *Id*.

B. General Philosophy of Making Returns

One may view the Form 706 as a type of offer to the IRS. The Form essentially reflects the executor's opinion of the estate's assets, their values and the tax due, which the executor contends the IRS should accept.[3] As is the case in any offer (especially in one with respect to which the offeror hopes the offeree to accept sight unseen), the Form 706 should be well presented, and include all relevant and material information regarding the property and their values.

The IRS is free to accept the Form 706 as filed, and usually does. But it may ask questions or conduct a full audit of the return. The author understands that

[3] The submitted Form 706 also may reflect an unfounded hope that the IRS might not take a close look at the return before accepting it.

the IRS almost always takes a closer look at returns which report valuation discounts associated with family owned businesses. If, in the end, the IRS determines that more tax is due based on its interpretation of the data and values, it may demand more tax, plus penalties and interest.

Practitioners have varying views on the level of effort and the level of aggressiveness that should be taken on an estate tax return. Several provisions of the Code should, in the author's view, temper any temptation to take an unsupportable position on a return. Certainly, the Form 706 must be "true, correct and complete" to the best of the executor's knowledge and belief and based on all information of which the preparer has any knowledge. Otherwise the executor and preparer will have committed perjury upon signing the return.

Further, Code Section 6662(a) imposes a substantial penalty of 20% of the underpayment of tax if the value of an asset is underreported by 65% or less of the value ultimately determined to be correct. The section was recently amended to include underpayments caused by basing a position upon a transaction that lacks economic substance. Code § 662(b)(6); *also see id*. § 7701(o) (defining the economic substance doctrine, which should come into play in the context of family held businesses in most situations). The penalty increases to 40% if the undervaluation is 40% or less than the finally determined value.

The taxpayer can escape the penalty, however, if the taxpayer had "reasonable cause" for the underpayment and acted in "good faith". Code § 6664(c)(1). Reliance on professional advice, that is, a qualified appraisal, might provide the necessary reasonable cause. *See id*. At a minimum, the taxpayer must show the appraisal (i) was "based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances"; (ii) was not based on unreasonable assumptions and did not unreasonably rely on the taxpayer's information; and (iii) was not based on the invalidity of a regulation. Regs. § 1.6664-4(b).

The Second Circuit provides further guidance in *Thompson v. Commissioner*, 499 F.3d 129 (2d Cir. 2007). In *Thompson*, the Tax Court had refused the Code Section 6662 penalty based on the taxpayer's reliance on a business valuation prepared by professional appraisals. *Id*. at 134. The Court of Appeals, however, reversed the Tax Court because it had not addressed whether the taxpayer had reasonably relied on its valuation expert and whether it knew or should have known the expert did not have the necessary expertise to value a company located in New York. *Id*. at 135.

A second penalty potentially applies almost any time there is an underpayment simply because the taxpayer did not obtain an appraisal. Code Section 6662(b)(1) imposes a 20% penalty on the underpayment if the underpayment is attributable to negligence. Negligence in this context means:

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

Regs. § 1.662-3(b)(1). "Reasonable basis" is a relatively high standard that goes beyond a merely arguable or colorable claim. *Id*. § 1.662-3(b)(3).

The tax return preparer also is personally subject to penalties if the preparer took an unreasonable position for which there was no substantial authority. Code § 6694. Appraisers are similarly subject to penalties for substantially understating or overstating the value of an asset. *Id*. § 6695A. Everything points to the preparer's high duty in making sure the return is true, correct and complete to the extent the preparer has any knowledge.

IV. LAYING THE GROUNDWORK FOR A WELL PREPARED FORM 706

A. The Basis for Decision Making

One cannot make wise decisions without accurate facts that are collected in a meaningful way. The basis for most decisions in the context of administering and closing an estate is the gross estate's inventory. The probate inventory is insufficient to provide much guidance in this process because it typically is not comprehensive. Development of a firm grasp of the gross estate's assets, including the surviving spouse's ½ community property share, and the information that needs to be gathered to complete an accurate inventory at the outset of administration is of vital importance. Nine months after death may seem like a long time in the abstract, but always seems to come faster in real life.

Draft schedules of the gross estate assist in the decision making process in several ways. First, they give an overall picture of the estate. Second, they expose whether there are sufficient assets to fund certain gifts, especially any gift to the Bypass Trust. Third, the draft schedule will indicate those assets, for example joint tenancy property, which might be available for funding gifts by way of qualified disclaimers. Fourth, and if properly prepared, the draft schedule also will expose those assets for which the fiduciary should seek an appraisal and whether the primary concern is related to estate taxes or capital

gains taxes. Finally, the schedule will assist in making the decision to fund distributions pro rata or non-pro rata and whether an exchange of property might be advantageous for the family.

B. Special Concerns Regarding Draft Schedules of the Gross Estate

Attorneys and their clients should take special care to preserve the confidentiality of all draft schedules of the gross estate. Most clients are woefully misinformed as to the true value of their assets, especially hard to value assets like closely held businesses. For example, they may estimate the value too high early in the process and before a qualified appraisal can be obtained. Only when the qualified appraisal is obtained do the attorney and the client learn that there is not a taxable estate.

The concern here is that if the confidentiality of the draft schedule is lost, the attorney-client and work product privileges may be lost. If so, the misinformed estimate found in a draft schedule might provide ammunition for an effective cross examination if the valuation ever comes under attack.

Regardless of the careful protection an attorney may afford a draft schedule, clients are not always so circumspect. An attorney can protect the client from himself or herself by careful drafting of the schedule. The draft schedule always should indicate on its face that it is a "draft". It also should note those values which are merely estimates and that appraisals should be obtained. Such language on the face of the document certainly would mitigate the effectiveness of any cross-examination based upon the draft if confidentiality is lost.

C. Is an Appraisal Required?

Under New Mexico law and in a typical unsupervised administration, the executor is the person who estimates the value of the estate's assets. *See* NMSA § 45-3-706(A). There is no duty to hire an appraiser, though the executor is free to hire one to assist in determining the value of an asset which may be subject to reasonable doubt. *Id*. § 45-3-707. On the other hand, the executor's fiduciary duties toward the beneficiaries of the estate may dictate that the executor determines the value of the property fairly in certain situations. A fair appraisal, however, does not require a formal opinion of value by a qualified appraiser.

Several situations may require that the executor arrange for a professional opinion as to value. The relative utility of an appraisal increases as the estate's beneficiaries' interests diverge and as the value of the estate increases, especially as it approaches the federal estate tax exemption amount. Examples of situations likely requiring a professional appraisal include, but are not limited to, the following:

- Funding of pecuniary bequests by making distributions in kind;
- Funding of residuary or general bequests through non-pro rata distributions;
- Funding of a bypass/credit shelter trust, even if pro rata distributions are made;
- Planned exchanges between the estate and a beneficiary, especially the surviving spouse;
- The overall value of the estate approaches the exemption amount (either to determine whether an estate requires a Form 706 or to comply with Form 706 reporting requirements); and
- To establish a new basis for capital gains tax purposes.

In any of these situations, cost will be a factor. The attorney and the client therefore will also have to weigh the risks and costs associated with not obtaining an appraisal with those of the appraisal itself. Many times, the question will be whether the executor is able to make do with a "cheap" appraisal or should obtain an "expensive" one. The risks to be weighed include the likelihood of litigation, the likelihood that the valuation used is correct and the costs associated with the valuation being wrong. Interestingly, IRS guidelines suggest the IRS conducts a similar cost/benefit and risk analysis when approaching an examination of a business valuation. *See* Internal Rev. Serv. Business Valuation Guidelines § 2.11, dated Jan. 14, 2002, eff. Oct. 1, 2002 (available in Hood, 830-2nd T.M., *Valuation: General and Real Estate*, Worksheet 6). That the IRS itself conducts a similar analysis suggests in and of itself that it is a good idea to have a well prepared appraisal supporting any hard to value asset in the estate.

D. The Code and IRS Regulations Regarding Appraisals

Nothing in the Code expressly requires that a taxpayer provide an appraisal prepared by a qualified appraiser in connection with a Form 706 or with closing an estate. *See* Code § 2031 (subsection (b), however, suggests an appraisal would be appropriate to determine the value of unlisted stock and securities). The regulations, however, either require appraisals or impose requirements on valuations that are, for all intents and purposes, appraisals. *See, e.g.*, Regs.§§ 20.2031-2(f) (valuation of stock when prices not readily available); 20.2031-3 (valuation of business interests); and 20.2031-6 (valuation of personal and household effects). An appraisal also must be provided if the estate includes valuable articles, such as antiques, collectibles, or jewelry, with a total value in excess of $3,000. Regs. § 20.2031-6(b). Even if a formal appraisal is not required by the regulations, appraisals

are advisable, from a practical standpoint, for hard to value items in the context of almost any Form 706.

For example, Code Section 7491 addresses the burden of proof in tax cases. Taxpayers who present "credible evidence with respect to any factual issue relevant to ascertaining the [taxpayer's] liability" are able to shift the burden of proof to the IRS. Code § 7491(a)(1). The burden shifts, however, only if the taxpayer also substantiated the item in dispute and reasonably cooperated with the IRS's requests for witnesses and documentation. *Id*. § 7491(a)(2). Courts have applied Code Section 7491's burden shifting to valuation cases. *See, e.g., Dailey v. Commissioner*, T.C. Memo 2001-263 (2001). It seems that a taxpayer armed with a well drafted and documented appraisal will be much more likely able to shift the burden of proof than one who decided not to spend the money up front.

E. Appraiser and Appraisal Standards

1. Appraiser Standards

A detailed discussion of the standards for appraisers and appraisal reports is beyond the scope of this paper. Attorneys advising executors and trustees should, nevertheless, keep in mind several basic issues when seeking out professional appraisers and reviewing draft appraisals before acceptance.

The Regulations do not provide general guidance in the context of estate or generation-skipping transfer taxes. Regulations in the gift tax arena, however, provide that guidance and, as a practical matter, probably should be followed in other areas as well. *See* Regs. § 301.6501(c)-1(f) (setting the standards for adequate disclosure in the context of triggering the statute of limitations for gift tax returns).

Under section 301.6501(c)-1(f) and at a minimum, the appraiser must satisfy the following:

- The appraiser is an individual holding himself or herself out to the public as an appraiser, or performs appraisals on a regular basis;
- The appraiser is qualified to make appraisals of the type of property at issue by virtue of the appraiser's background, experience, education and memberships in professional appraisal associations, if any; and
- The appraiser is not a family member of the donor's family or a person employed by the donor's family.

Regs. § 301.6501(c)-1(f)(3)(i). One issue raised by these standards is whether the family's CPA firm might be the right choice for preparing the valuation of the decedent's closely held business. While the regulations do not apply, technically, to disqualify the family's CPA firm to act as an appraiser, a long time relationship does raise questions as to impartiality.

For certain types of assets, the estate tax regulations contain specific requirements for appraisers. For example, appraisers of household and personal effects must be "reputable and of recognized competency to appraise the particular class of property involved." Regs. § 20.2031-6(d). The numerous and difficult to determine factors required to be considered in valuing small businesses also, by necessity, require a certain level of competency and experience for appraisers as well. *See Id*. §§ 20.2031-2(f), 20.2031-3 (the factors to be considered are discussed below). An attorney's failure to ensure that competent appraisers are hired may produce disastrous results.

2. Appraisal Standards

To be considered adequate, the appraisal itself must contain the following information (again, in the context of adequate disclosure for gift tax returns, which should provide guidance for estate tax returns):

- The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;
- A description of the property;
- A description of the appraisal process employed;
- A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;
- The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;
- The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;
- The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and
- The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Regs. § 301.6501(c)-1(f)(3)(ii). Revenue Procedure 66-49, which was decided in the context of the income tax, provides further guidance as to the type of information that any appraisal should include. The

procedure requires:

- A summary of the appraiser's qualifications;
- A statement of the value including the appraiser's definition of value;
- The bases for the opinion, including a description of any restrictions regarding the use or disposition of the property;
- The valuation date; and
- The appraiser's signature and date of the appraisal.

REV. PROC. 66-49.

Care should be taken to ensure the appraiser uses the correct definition of fair market value, which can change, depending on the context. For purposes of estate tax returns, "fair market value" means, as of the date of death, "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts". Regs. § 20.2031-1(b). All appraisals for estate tax purposes should indicate use of this definition of fair market value.

Clearly, any appraisal of an item should address the issues raised in the regulations for that type of item, if any. The general principles for valuation set forth in section 20.2031-1(b) of the regulations, for example, set forth examples of how to return values of certain items, like automobiles, livestock and crops. They also typically require that values be returned on an itemized basis, rather than for lots. Regs. § 20.2031-1(b). Also, the executor must take several factors into consideration in valuing stock and other business interests for which there is no ready market. *Id*. §§ 20.2031-2(f)(1), (2) (the other relevant factors include the company's net worth, prospective earning power, good will, economic outlook, management, and non-operating assets); 20.2031-3 (same).

Revenue Ruling 59-60 also must be consulted in connection with any valuation of a closely held business. It sets forth the appropriate methods for valuing a company, the specific factors for consideration, and the weight to accord to various factors. REV. RUL. 59-60. Also, section 20.2031-6(d), which governs valuation of personal and household effects, contains specific requirements for the appraisals of certain types of items like books, oriental rugs, paintings and silver. Any appraisal that ignores these requirements (or fails to include them because of oversight) will be subject to attack.

Sample appraisals for real estate can be found at Worksheets 1 through 5 of Hood, 830-2nd T.M., *Valuation: General and Real Estate* (2003).

F. Preparing for Possible Litigation in the Future

1. General Considerations

Litigation over the value of an asset, or the value of the entire estate, probably is very far from the minds of most executors and the attorneys who represent them, especially when no 706 is being filed. The risk of any valuation, however, is that someone, perhaps a beneficiary or the IRS, will question the valuation, and litigation will ensue.

The best course in the context of any actual litigation is to prepare the case as if it will go to trial despite the likelihood of settlement. Such preparation will ensure the best prosecution or defense of the matter regardless of when and whether the case settles. A similar attitude of preparation should be taken in the context of closing estates. Granted, the likelihood that any particular estate might be involved in future litigation may be very small. The potential harm to the estate, however, can be very great, especially for taxable estates and those that may or may not be taxable depending on a valuation of a particular item. Therefore, valuations and the engagement of appraisers should be viewed with an eye towards the future possibility of a fight.

While an expert witness as to valuation typically can be hired well after actual litigation has begun (*see* FED. R. CIV. P. 26(a)(2)(C) (absent court order, expert witness disclosures due 90 days before trial)), that expert witness almost certainly will be at a disadvantage as compared to the witness who was hired to prepare the valuation in the first place. The disadvantage arises because of the passage of time. The only values that are of relevance are those as of the date of death (or six months later if an alternate valuation date is chosen) and the date of distribution, especially in the context of fairly representative non-pro rata distributions. *See* Code §§ 2031(a) (date of death value); 2032 (alternate valuation date); REV. PROC. 64-19 (fairly representative funding). These dates tend to be well in the past by the time litigation has begun. In the meantime, markets have changed, the real estate might have been developed, or the business may have changed its focus and management. If the expert is unable to base his or her opinion on relevant facts, the opinion will be worthless. Therefore, the attorney advising an executor closing an estate or filing a 706 should keep in mind the rules regarding admissibility of expert opinions at trial and make every effort to obtain an admissible opinion from the outset.

2. Admissibility of Expert Opinions

Rule 702 of the Federal Rules of Evidence governs the admissibility of expert opinions. The rule also is applicable in the Tax Court. TAX CT. R. 143. The rule states, in whole part:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

FED. R. EVID. 702; *compare* NMRA 11-702 (which does not include the "if" clause). An appraiser's opinion typically falls under either technical or specialized knowledge that would assist in determining the fact at issue. In the seminal cases, *Daubert v. Merrell Dow Pharmaceuticals, Inc*., 509 U.S. 579, 589 (1993) (scientific knowledge) and *Kuhmo Tire Co. v. Carmichael*, 526 U.S. 137, 141 (1999) (technical and specialized knowledge), the Supreme Court introduced the now standard concept that the trial judge acts as a gate keeper for evidence introduced under the guise of expert opinion.[4] Under these standards, the trial judge is required to determine that the proffered evidence is both relevant and reliable. *Kuhmo Tire Co*., 526 U.S. 147. The Tax Court regularly takes on the role as the gate keeper and excludes expert evidence as unreliable. *See, e.g., Estate of Noble v. Comm'r,* T.C. Memo 2005-2 (2005) (excluding expert report because unreliable).

The attorney must refrain from participating too much in any expert appraisal. In at least two cases, the Tax Court has excluded the taxpayer's expert valuation report as unreliable because the evidence suggested the report was tainted by significant participation in the report's preparation by the taxpayer's counsel. *See, e.g., Estate of Noble v. Comm'r,* T.C. Memo 2005-2 (2005); *Bank One Corp. v. Comm'r*, 120 T.C. 174 (2003). For a report to be reliable, the expert's report must be the expert's report, not the attorney's.

Communications between the taxpayer's counsel and the appraiser who ultimately acts as an expert witness will be discoverable. FED. R. CIV. P. 26(a)(2)(B)(ii) (parties must disclose "the data or other information considered by the [expert] witness in forming" his or her opinions). Attorney work product also may not work to protect the attorney's own notes when merely closing an estate in most cases. The work product doctrine only applies to protect documents and tangible things prepared in anticipation of litigation. *Id*. 26(b)(3)(A). At the stage of closing an estate, it would be difficult to establish that the taxpayer was anticipating litigation other than from a purely theoretical standpoint. Therefore, the attorney must take great care in communicating with the potential expert witness so as not to taint the expert's opinion and create unnecessary cross examination material.

3. <u>The Weight of Expert Opinion Evidence</u>

All appraisers should be evaluated for factors that go beyond price and the appraiser's willingness to provide a favorable opinion. (Rather than a favorable opinion, smart attorneys seek honest opinions based on facts and law regardless of whether the opinion is favorable. Besides being what should be considered anathema, mere "favorable" opinions only serve as fodder for effective cross examinations and ruin the credibility of the party utilizing them.) Among the plethora of issues to consider is whether the proposed expert will appear to be disinterested to the fact finder. The Tax Court has, for example, discounted an appraiser's opinion because of a long time business relationship with the decedent and the decedent's family, providing another reason to seek an independent appraiser. *See Estate of Dougherty v. Comm'r*, T.C. Memo 1990-274 (1990).

Other factors to consider when engaging a valuation expert center on the issue of whether the expert "makes a good witness". Issues to consider include:

- Is the appraiser articulate?
- Does the appraiser seem credible when speaking?
- How does the appraiser react under pressure, especially when cross examined?
- Does the appraiser have credentials?
- Do other appraisers recognize the credentials as meaningful?
- Has the appraiser been published? In the area of concern? Do the published articles corroborate the opinion in this case?
- Has he or she testified before?
- If so, has the witness testified for taxpayers exclusively?
- How does the appraiser's fee compare to fees in the marketplace for appraisals?
- If the fee is higher than average, does the appraiser's education or experience warrant the higher fee?
- Has the appraiser been convicted of a felony or a crime involving dishonesty?

[4] The New Mexico Supreme Court also adopted essentially the same standard with respect to scientific knowledge in *State v. Torres*, 1999 NMSC 10, ¶ 24. Remarkably, however, a quick search did not reveal that the New Mexico Supreme Court (or any New Mexico court) has adopted the standard with respect to technical and specialized knowledge as the U.S. Supreme Court did in *Kuhmo Tire*. At least, no New Mexico court has cited the opinion.

- Has the witnessed been censured or disciplined by his or her credentialing agency?

The list could go on. The point is that attorneys should investigate their valuation experts before becoming committed to them.

4. Lay Opinion Testimony

Under the Federal Rules of Evidence, lay opinion testimony is admissible under certain circumstances. FED. R. EVID. 701. A non-expert witness may testify as to opinions, but only those "which are (a) rationally based on the perception of the witness, and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue". *Id*. Lay opinion testimony is not, however, admissible if it is based on technical or specialized knowledge that would otherwise be within the purview of an expert's testimony. *Id*. Given that the regulations regarding valuation are, at times, somewhat technical, it seems that it would be a tactical mistake to rely solely on lay opinion testimony in a valuation dispute.

V. SPECIFIC PORTIONS OF THE FORM 706

A. The Gross Estate

A decedent's gross estate is the fair market value of all of his or her property, real or personal, tangible or intangible, situated anywhere in the world. Code § 2031(a), *also see id*. § 2033 ("The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."). Certainly, the gross estate will include all property that generally is considered owned by a person and are relatively easy to identify. These types of properties include real property interests, which are reported on Schedule A of the Form 706, stocks and bonds, which are reported on Schedule B, and mortgagees, notes and cash, all of which are reported on Schedule C.

But some assets are not clearly owned. Nevertheless, the Code includes those types of property which benefit the estate or over which the decedent had enough power over the property that it should be included. For example, the special types of property that are part of the gross estate include: dower or curtesy interests (*Id*. § 2034), certain gifts made within three years of death (*Id*. § 2035), transfers with retained life estates (*Id*. § 2036), transfers taking effect at death (*Id*. § 2037), revocable transfers (*Id*. §2038), annuities (*Id*. § 2039), joint interests (*Id*. § 2040), general powers of appointment (*Id*. § 2041), and proceeds from life insurance (*Id*. § 2042).

The estate's various assets are itemized on Schedules A through I of the Form 706. The asset's characteristics dictate the particular Schedule on which it should be reported. For example, a bank account will be reported on Schedule C. On the other hand, if the decedent held the bank account as a joint tenant with rights of survivorship with another person, the account will be reported on Schedule E (jointly held property). It is the sum total of these assets that forms the decedent's gross estate and is reported on Part 1, line 1 of the Form 706.

The author and Ms. Castellano-Piatt have divided the Schedules among them. Accordingly, this paper will not discuss each Schedule.

1. *Schedule D – Insurance on the Decedent's Life*

Under Code § 2042, the proceeds of any life insurance policy on the life of the decedent is included in the gross estate in two situations. First, if the proceeds are payable to the decedent's estate (regardless of who owned the policy), the proceeds are included. Code § 2042(1). Second, any policy over which the decedent possessed the incidents of ownership also will be included in the decedent's gross estate. *Id*. § 2042(2).

The Code does not provide much guidance in determining just what an incident of ownership might be. It merely states that an incident of ownership includes a reversionary interest which exceeds 5% of the policy's value immediately before the decedent's death. Code § 2042(2). The statute states, in relevant part:

> [T]he term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent.

Id. The Regulations provide further guidance. They state that "incidents of ownership" go beyond ownership in a "technical legal sense". Regs. § 20.2042-1(c)(2). Rather, the term refers to "the right of the insured or his estate to the economic benefits of the policy". *Id*. The term therefore includes:

> [T]he power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

Id. For a policy held in trust, the insured is considered to have an incident of ownership if he or she has powers over the policy benefits. *Id*. § 20.2042-1(c)(4). Specifically, the insured has an incident of ownership

if he or she (either alone or in conjunction with someone else):

> [H]as the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

Id. Further, if the insured created the trust, the insured has an incident of ownership if he or she has the power to surrender the policy and divert the trust's income that otherwise would be used for premium payments to the trust's beneficiaries. *Id*.

The instructions to Schedule D, which appear in Form 706 rather than the Instructions for Form 706, also list some examples. They are:

- The right of the insured or estate to the policy's economic benefits;
- The power to change the beneficiary;
- The power to surrender or cancel the policy;
- The power to assign the policy or to revoke an assignment;
- The power to pledge the policy for a loan;
- The power to obtain from the insurer a loan against the surrender value of the policy; and
- A reversionary interest, as described above.

See Form 706, Schedule D Instructions.

The Code and regulations also expound on the phrase "reversionary interest", which can give rise to an incident of ownership. Code § 2042(2); Regs. § 20.2042-1(c)(3). A "reversionary interest" is described as a possibility that the policy proceeds will come back to the estate through some circuitous route. Code § 2042(c). The Code states, in relevant part:

> The term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him.

Id. The regulations go on to state that the reversionary interest may arise by the policy's express terms, some other instrument or operation of law. Regs. § 20.2042-1(c)(3). Neither the terms "reversionary interest" nor "incident of ownership" include, however, the possibility that the insured might receive the policy or its proceeds through inheritance or as a surviving spouse. *Id*.

Form 706, Part 4, Question 8a seeks information regarding life insurance on the decedent's life that is not included in the gross estate. Examples would include life insurance policies owned by an irrevocable life insurance trust ("ILIT") or a child. Similarly, Question 8b seeks information about whether the decedent owned a life insurance policy on the life of another. The goal is to trigger a look at whether the policy had any cash value or might be sold in a viatical settlement and whether that value should be part of the gross estate.

The Instructions to Schedule D require that the executor list every policy on the decedent's life regardless of whether the policy's proceeds are includable in the gross estate under Code § 2042. *See* Form 706, Schedule D Instructions. For each policy, the name of the insurance company issuing the policy and its number must be reported. The executor also must submit a Form 712 for each policy. Only the insurance company can prepare the Form 712, so the executor should request the form or forms early in the estate's administration. If a policy is not includable, the executor must explain why.

The return preparer must not assume that an insurance policy transferred to an ILIT is outside the decedent's gross estate. For example, a poorly drafted ILIT might contain a provision requiring the trustee to pay the decedent's debts or estate taxes. Such a provision would cause inclusion in the estate.

Note that a properly prepared Form 706 might not include all life insurance policies on Schedule D. A particular policy might be includable in the estate for some reason other than Code § 2042. For example, a life insurance policy in a properly drafted irrevocable life insurance would avoid inclusion under section 2042. But if the transfer of the policy took place within three years of death, it would be includable under section 2035. As such, it would be reported on Schedule G.

2. *Schedule E – Jointly Owned Property*

Code § 2040 includes property in which the decedent had a joint interest with rights of survivorship, or as tenants by the entirety. Code § 2040(a); Regs. § 20.2040-1(a). The question in the context of preparing an estate tax return revolves around how much of that jointly held property should be included in the estate. The answer typically depends on the extent to which the other joint owner contributed adequate and full consideration for his or her joint interest. Code § 2040(a); Regs. § 20.2040-1(a)(2). To escape inclusion of the entire property, the decedent's estate must submit facts establishing the other joint owner's contribution to the property. Regs. § 20.2040-1(a). The Instructions to Schedule E, which appear as part of Form 706, add that the full value of jointly held property should be included unless the estate can establish part or all of the property belonged to the other joint tenant. Form 706, Schedule E Instructions. For example, the estate must show that the other tenant did not receive his or her interest for

less than full and adequate consideration from the decedent (at any time) or that the other tenant acquired the interest with consideration originally belonging to the other tenant. *Id*. Alternatively, the estate also may establish the other joint tenant acquired his or her interest in the jointly held property by gift or inheritance from a third party. *Id*.

In New Mexico, and in other community property states, a spouse generally is presumed to have a one-half community property interest in jointly held properties. *See* NMSA § 40-3-8(B) ("Property acquired by a husband and wife … as tenants in common or as joint tenants or otherwise shall be presumed to be held as community property."). Therefore, Section 2040 generally causes proof issues for New Mexico residents only in the context of the decedent holding an asset as joint tenants with someone other than a spouse. The typical scenario is when a parent is a joint tenant with a child, generally for convenience purposes. Unless the child can show that he or she contributed to the account, the entire account will be included in the decedent's gross estate.

Except for property held as tenants in common, joint interests of all types, including those that would otherwise be reported on another Schedule, are reported on Schedule E. The joint interest may include, for example, real property, personal property, and bank accounts. *See* Form 706, Schedule E Instructions. Again, property held as tenants in common with another person are not listed on Schedule E. *Id*.

If the decedent's spouse was the only other joint tenant, the joint interest is reported on Part 1 of Schedule E. Form 706, Schedule E Instructions. All other joint interests are reported on Part 2 of the Schedule. *Id*. The executor must submit proof of the other joint tenant's property rights if only a portion of the property is included in the return. *Id*.

An often overlooked point involves the alternate valuation election under Code § 2032. Typically, if property is transferred from the estate, it is a disposition that sets the value for the alternate valuation. The transfer by operation of law of a joint tenancy, however, is not a disposition. *See* REV. RUL. 59-213.

3. *Schedule F – Other Miscellaneous Property*

Schedule F likely will be the longest Schedule in the entire return. The Schedule also is more likely to list hard to value assets that will require a qualified appraisal. (*See* the discussion below on appraisers and appraisals.) Many various types of property should be reported on the Schedule and include any property that does not fit within the categories for the other Schedules. For example, Part 4, Question 6 of Form 706 seeks information as to whether the decedent was the beneficiary of a qualified terminal interest property ("QTIP") trust. If so, the IRS will expect to see both a description of the QTIP trust on Schedule F and a copy of the trust as an attachment. *Also see* Question 16, which seeks similar information. Questions 10a and 10b seek information as to whether the gross estate included an interest in a closely held company and whether a valuation discount was taken. If the answer is yes, Schedule B (for corporations) or Schedule F (partnerships and limited liability companies) must be completed and the IRS will be looking for a business appraisal meeting the requirements of REV. RUL. 59-60. Further, a complete description of the valuation discount taken must be included. See Form 706, Instructions to Schedule F.

The Instructions to Schedule F, which appear immediately after the Schedule in Form 706, list several examples of the types of property that would be included on the Schedule. In some ways, the list may serve as a checklist for the executor to ensure all miscellaneous property interests owned by the decedent have been included. Unfortunately, and given the creativity of lawyers in creating property rights, the list is far from complete. The list includes:

- Debts due the decedent other than notes and mortgages included on Schedule C;
- Interests in unincorporated businesses, including sole proprietorships, general partnerships, limited partnerships and limited liability companies;
- Interests in Archer medical savings accounts and health savings accounts, except those that pass to a surviving spouse;
- Insurance on the life of someone other than the decedent;
- Qualified terminal interest property for which the tax was deferred from the estate of the decedent's deceased spouse;
- Claims against others (including claims for tax refunds and pending lawsuits);
- Miscellaneous contract rights;
- Royalties;
- Leaseholds;
- Judgments;
- Vested reversionary or remainder interests;
- Beneficial interests in trusts;
- Household goods and personal effects, including wearing apparel;
- Farm products and growing crops;
- Livestock;
- Farm machinery; and
- Automobiles.

Form 706, Schedule F Instructions. Obviously, the list is not exhaustive. Other types of property interests that should be included on Schedule F include:

- Retirement accounts, like 401(k) and individual retirement accounts;
- Patents, licenses, trademarks and copyrights;
- Salary and benefit continuation plans for surviving spouses;
- Uncashed checks;
- Refundable deposits and prepayments;
- Fine art and collectibles;
- Death benefits from Social Security and workers' compensation; and
- Wrongful death recoveries.

See Peebles & Janes, 822-2nd T.M., *Estate, Gift, and Generation-Skipping Tax Returns and Audits*, III(F).

Some of the assets included in the gross estate by specific statute are reported on Schedule F. They include dowers or curtesies under Code § 2034 and QTIP Trusts under Code § 2044. Both types of property interests are described below.

At common law, a "dower" was "the legal right or interest that a wife acquires in the estate of her husband". AM. JUR. 2d, Dower and Curtesy § 1. The concept of dower has been modified by statute in many states. *Id*. A "curtesy" was, on the other hand, a "life estate given to a husband in the real property of which his wife dies seised of an estate of inheritance, provided that live issue is born of the marriage and no testamentary disposition or prior conveyance is made by the wife". *Id*. § 2. New Mexico law has abolished both dower and curtesy estates. NMSA § 45-2-112. Neither is necessary in New Mexico because spouses are protected through New Mexico's community property regime. Therefore, for most domiciliaries of New Mexico, the concept of dower or curtesy should not be a cause for concern.

Because they are the result of a common method of deferring estate taxes in large estates, qualified terminal interest property trusts ("QTIP trust") also might be encountered. *See* Code § 2056(b)(7) (providing the marital deduction for property in a QTIP trust). The QTIP trust only defers estate taxes until the second spouse dies. Code § 2044 operates to include the value of property in the QTIP trust in the surviving spouse's gross estate, regardless of whether the surviving spouse has a power of appointment over the trust. Code § 2044(a); Regs. § 20.2044-1(a). As indicated in the Instructions, QTIP trusts are reported on Schedule F.

4. *Schedule G – Transfers During the Decedent's Life*

Most gifts are not included in a decedent's estate because the decedent does not retain any rights in the property. If the decedent retained any rights in the property, however, or made certain gifts within three years of death, the Code may operate to require such assets to be included in the gross estate. To elicit a report of such gifts, Part 4, Question 11 of Form 706 seeks an answer as to whether the decedent made any transfers subject to Code sections 2035 (certain gifts within 3 years of death), 2036 (transfers with retained life estates), 2037 (transfers taking effect at death), or 2038 (revocable transfers). A yes answer requires completion of Schedule G. The following types of gifts are included, valued as of the decedent's date of death, not the date of the transfer. All are reported on Schedule G. Note that the instructions for Schedule G actually appear in the Instructions for Form 706, beginning at page 15.

a) Certain Gifts within Three Years of Death – (Code § 2035)

Under Code § 2035, the gross estate includes any property of which the decedent made a gift or otherwise relinquished a retained power for less than full and adequate consideration within three years of his or her death and the property would have otherwise been included in the estate under Code §§ 2036 (retained life estates), 2037 (transfers taking effect at death), 2038 (revocable transfers) and 2042 (proceeds of life insurance). Code § 2035(a), (d) (note that there is no corresponding Regulation for Code § 2035). The most common situation raising section 2035 is the creation of an irrevocable life insurance trust to which the decedent transferred an existing life insurance policy. In that case, the life insurance proceeds would be included in the gross estate regardless of the effectiveness of the ILIT in general. Further, if the decedent paid gift taxes within three years of death, the taxes also are reported as an asset on Schedule G. *See* Code § 2035(b); Instructions to Form 706, p. 15.

Other situations also might arise. For example, assume an astute estate planning lawyer spots a retained right in a family limited partnership that would cause the FLP to be included in the estate as a retained life estate under Code § 2036. If the decedent gave up that right within three years of death, the value of the right would be included under section 2035. In each instance, the return should include the same documentation that would be provided under the Schedule on which the asset would have been reported had the decedent not given it away. *See* Instructions to Form 706, p. 15.

b) Transfers with Retained Life Estates - (Code § 2036)

The property that is included in the decedent's estate under Code § 2036 is property the decedent transferred to someone else, but in which the decedent retained a life estate. Code § 2036. Generally speaking, life estates include any property over which the decedent had either (i) "the possession or

enjoyment of, or the right to the income from, the property", or (ii) "the right, either alone, or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." *Id*. § 2036(a); *also see* Regs. § 20.2036-1 (which goes into significant detail interpreting the statute). The Code section is triggered if the decedent had transferred the property, save for the life estate, by any means except through "a bona fide sale for an adequate and full consideration in money or money's worth." Code § 2036(a).

The Instructions to Schedule G indicate that the preparer should be looking for transfers with the following characteristics:

- The retained right to income from the transferred property;
- The retained right to the possession or enjoyment of the property; and
- The retained right, either alone or with any person, to designate the persons who will receive the income from, or possess or enjoy, the property.

Instructions to Form 706, p. 15. Examples of a retained right to income include transfers to trusts from which the decedent retained an annuity or unitrust interest, if the trust either is for the decedent's life or does not, in fact, terminate before the decedent's death. *See* Regs. § 20.2036-1(c)(2); Instructions to Form 706, p. 15. Specific examples of this type of asset would include grantor retained annuity trusts ("GRATs") and qualified personal residence trusts ("QPRTs"), the beneficiary of which died before the trust terminated. Retained voting rights, whether direct or indirect, in connection with the gift of stock in a controlled corporation also are considered to be a retained life estate. Code § 2036(b); Instructions to Form 706, p. 15.

Retained life estates do not have to be legally enforceable. For example, the Instructions point out that an asset will be included if the decedent simply retained a substantial economic benefit. Instructions to Form 706, p. 15. As an example, the Instructions point to a mother who transferred title to her home to her daughter, but continued living in the home, rent free. Despite that the daughter allowed her mother to stay gratuitously and could have evicted her, the house is included in the estate. *Id*. The preparer should not, however, take the Instructions at face value. Instead, the preparer should carefully review relevant case law to determine if a contrary position is colorable when presented with similar facts.

It is Code § 2036 and the case law developed under it that primarily drives the structure and formation of family limited partnerships and family limited liability companies. Because section 2036 requires that the value of the entire property, not just the retained life estate, be included in the gross estate, inclusion under this section generally is caused by a mistake or over aggressiveness in estate planning. The inclusion also likely will prove to be an estate tax planning fiasco. Not only is the value of the entire asset included in the decedent's gross estate, but the transfer for less than adequate consideration also was necessarily a gift. *See id*. § 2512(b) (the difference between full and adequate consideration and the consideration received is deemed to be a gift). The situation gets worse if the gift with a retained life estate was given to a family member. *See id*. § 2702(a) (the value of the gift to a family member in this situation is the value of the property ignoring the retained life estate). Faulty planning can lead to double taxation tempered only by the credit for gift taxes paid under Code § 2012.

Note that Code § 2043 operates to reduce the result of section 2036 somewhat. Under section 2043, the transferred property is included only to the extent its value exceeds the actual consideration paid to the decedent. Code § 2043(a); Regs. § 20.2043-1(a).

c) <u>Transfers Taking Effect at Death - (Code § 2037)</u>

Code § 2037 is designed to capture the value of assets in which the decedent made a lifetime gift of property to another, but retained a reversionary interest in the property, under certain circumstances. Specifically, the value of the property is included if (i) the decedent transferred an interest in property for less than full and adequate consideration; (ii) in which full ownership can only be obtained by surviving the decedent; and (iii) the decedent retained a reversionary interest in the property, the value of which exceeds 5% of the value of the property itself. *Id*. § 2037(a); *also see* Regs. § 20.2037-1(a). A "reversionary interest" is a possibility that the property will return to the decedent or his estate or may be subject to a "power of disposition". Code § 2037(b); Regs. § 20.2037-1(c)(2). The Regulations make clear that mere operation of law can create a reversionary interest. Regs. § 20.2037-1(c)(2). Fortunately, the Regulations also specifically exclude the possibility of inheritance as creating a reversionary interest. *Id*.

Again, Code § 2043 operates to exclude the value of the consideration the decedent received for making the transfer. Code § 2043(a); Regs. § 20.2043-1(a).

d) <u>Revocable Transfers - (Code § 2038)</u>

A "revocable transfer" under Code § 2038 is, generally speaking, one which the decedent was able to amend, revoke or terminate. Code § 2038(a)(1); Regs. § 20.2038-1(a). The power to make these changes can arise in many forms. The most common example is a

living trust. Further, if the decedent established an irrevocable trust for a child, but retained the power to remove the trustee at any time and appoint himself as trustee, the decedent made a revocable transfer. *See* Regs. § 20.2038-1(a)(3).

Custodial accounts under the Uniform Transfer to Minors Act ("UTMA") also create section 2038 problems for parents. *See* NMSA §§ 46-7-11, *et seq.* (the New Mexico version of UTMA). Nothing prohibits the parent from using the custodial account in a manner that would discharge his or her legal duty to support the child. Accordingly, an UTMA account may be includable. *See* Rev. Rul. 74-556. Section 529 plans over which the decedent was custodian, however, are not includable in the decedent's estate by a specific provision in the Code. Code § 529(c)(4)(A).

Section 2038 also comes into play in the world of family limited partnerships and family limited liability companies when the patriarch or matriarch attempts to retain too much control over the entity.

Like transfers with retained life estates and transfers taking effect at death, Code § 2043 operates to exclude the value of the consideration the decedent received for making the transfer for revocable transfers, if any. Code § 2043(a); Regs. § 20.2043-1(a).

5. *Schedule H – General Powers of Appointment*

Under Code § 2041, the value of any property over which the decedent has a general power of appointment is includable in the decedent's estate. Code § 2041(a)(2). The value of the property is included even if the decedent had previously exercised or released the power in such a way that the property would have been included under Code Sections 2035 through 2038. *Id.*

A "power" is "a liberty or authority reserved by, or limited to, a person to dispose of real or personal property for his or her own benefit or for the benefit of others". AM. JUR. 2d, Powers of Appointment and Alienation § 1. A person who owns the fee simple interest in certain real estate, for example, holds a power over that property. A power, however, is separate from ownership of the beneficial interest in the property itself. *Id.* A "power of appointment" is a subset of powers in general, and is a power to designate recipients of beneficial interests in property. *Id.*; Restatement 2d, Property (Donative Transfers) § 11.1.

Federal law defines "powers of appointment" in a rather circular fashion that both relies on state law definitions, and also ignores local usage of the term. *See* Regs. § 20.2041-1(b)(1). Incredibly, the Regulations essentially define "power of appointment" as a power of appointment. Specifically, the Regulations state, in part:

> The term "power of appointment" includes *all powers which are in substance and effect powers of appointment* regardless of the nomenclature used in creating the power and regardless of local property law connotations.

Id. (emphasis added). The Regulations also present several examples of powers of appointment. *Id.* The examples are:

- A beneficiary's power to appropriate or consume the principal of a trust;
- A power to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust; and
- Certain broad powers held by a trust beneficiary to remove or discharge a trustee and appoint himself or herself as the successor. For example, if the trustee or his successor has the power to appoint trust principal for the benefit of individuals including himself or herself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent has a power of appointment.

Id. Fortunately, the Regulations also provide examples of powers that are not powers of appointment for purposes of federal transfer taxes. *Id.* The examples of non-powers of appointment are:

- A trust beneficiary's power to appoint a successor Trustee, including himself or herself, under limited conditions which did not exist at the time of the beneficiary's death, without an accompanying unrestricted power of removal;
- A power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income;
- The mere power of management, investment and custody of assets;
- The power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties; and
- A beneficiary's right to assent to a periodic accounting, thereby relieving the trustee from further accountability, if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

Id.

A beneficiary's mere power of appointment over certain property, however, is not sufficient for that property's inclusion in the beneficiary's gross estate. Rather, the beneficiary must hold a "general power of appointment" over the property. Code § 2041(a)(2); Regs. § 20.2041-1(a). Generally speaking, a "general power of appointment" is "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate". Code § 2041(b)(1); *also see* Regs. § 20.2041-1(c)(1). The Regulations provide two types of powers which necessarily are within the general definition:

- A power exercisable to meet the decedent's estate tax, or any other taxes, debts, or charges which are enforceable against his or her estate; and
- A power exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit.

Regs. § 20.2041-1(c)(1). Three major exceptions apply, which remove significant powers from the realm of general powers of appointment. The exceptions are:

- A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent. Code § 2041(b)(1)(A), *also see* Regs. §§ 20.2041-1(c)(1) and (2). Note that the terms "support" and "maintenance" are synonymous under the Regulations and, fortunately, are not limited to "the bare necessities of life". Regs. § 20.2041-1(c)(2). Discretion to make distributions for a person's "comfort", "welfare", or "happiness", however, does not meet the requisite ascertainable standard. *Id*. On the other hand, discretion to make distributions for a person's "support", "support in reasonable comfort", "maintenance in health and reasonable comfort", "support in his accustomed manner of living", "education, including college and professional education", "health", and "medical, dental, hospital and nursing expenses and expenses of invalidism" does meet the requirement for ascertainable standards. *Id*. The Regulation does not come out and specifically state it, but discretion to make distributions for a person's "health, education, maintenance and support" necessarily falls within the required ascertainable standard to avoid a general power of appointment. *See id*.
- A power exercisable by the decedent in favor of himself, his estate, his creditors, or the creditors of his estate, but only in conjunction with the creator of the power. Code § 2041(b)(1)(C)(i), *also see* Regs. § 20.2041-3(c) (providing further detail); and
- A power exercisable by the decedent in favor of himself, his estate, his creditors, or the creditors of his estate, but only in conjunction with a person having a substantial interest in the subject property, which is adverse to exercise of the power in favor of the decedent. Code § 2041(b)(1)(C)(ii), *also see* Regs. § 20.2041-3(c) (providing further detail).

Fortunately, with all of the varying exceptions and limits relating to general powers of appointment the Regulations provide a couple of safe harbors. *See* Regs. §§ 20.2041-1(c)(1)(a) and (b). The two safe harbors are as follows:

- If the power is exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or its creditors, the power is not a general power. Regs. § 20.2041-1(c)(1)(a); and
- If the power is expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate, the power is not a general power. Regs. § 20.2041-1(c)(1)(b).

Powers of appointment generally are found in trusts of which the decedent is a beneficiary or grantor. Careful legal review of the terms of any such trusts is necessary to determine whether the decedent had a general power of appointment. Knowledge and review of local law also will be necessary to determine whether statutes or case law expand or restrict the terms of the trust either to create or avoid a general power of appointment. Note that the IRS also will be reviewing the terms of the trust as a copy must be included with the Form 706. The IRS also is fairly aggressive with respect to bypass/credit shelter trusts of which the surviving spouse is the trustee.

Many trusts also include what is known as a five and five power under Code § 2041(b)(2). If the decedent died during the time in which the decedent could have exercised the power, the value of that power will be included in the gross estate. A decedent also might have a *Crummey* power, which gives a beneficiary the power to demand withdrawal of a previous gift to an irrevocable trust. Depending on the specific facts, the power might be includable.

Code § 2043 operates to exclude the value of the consideration the decedent received for making the

transfer. Code § 2043(a); Regs. § 20.2043-1(a). The credit for estate taxes paid on prior transfers under Code § 2013 also might provide some relief if the general power of appointment is held over property which was subject to the estate tax within the last ten years.

6. *Schedule I - Annuities*

An "annuity" for purposes of Code Section 2039 is defined as a:

> contract or agreement … (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

Code § 2039(a); *also see* Regs. § 20.2039-1. Annuities may be either private annuities (that is, an annuity between private parties) or commercial, which are available on the market. Private annuities, especially those with family members, regularly involve questions related to retained life estates and Code § 2036.

Commercial annuities, on the other hand, are pretty straight forward and are easy to recognize. They are valued under Regs. § 20.2031-8 and the issuing company will typically issue a Form 712 on request. Other annuities are valued using the actuarial tables prescribed by Code § 7520.

Note that very specific rules and regulations govern annuities held within qualified retirement plans. *See* Regs. § 20.2039-1(c); Instructions to Form 706, p. 18.

B. Allowable Deductions

The taxable estate is equal to the decedent's gross estate less certain deductions. Code § 2051; Regs. § 20.2051-1(a). The Regulations and Part 5 of Form 706 list the allowable deductions for an estate.[5] *See* Regs. § 20.2051-1(a). The deductions include the following expenses and claims against the estate:

- Funeral expenses;
- Administration expenses;
- Debts, mortgages and liens;
- Net losses during administration; and
- Expenses incurred in administering property not subject to claims.

Id.; a*lso see* Code § 2053(a) (listing allowable expenses as deductions), 2054 (losses as deductions). In general, each of the elements also must satisfy several requirements found in section 20.2053-1 of the Regulations. Those requirements include that the claim is allowable against the estate by the law of the local jurisdiction, and that the claim is bona fide, that is, the claim is not a disguised gift or inheritance to the recipient. *See* Regs. § 20.2053-1 (also providing further restrictions). Because of the requirement that a particular expense or claim against the estate must be established under local law and given the dearth of case law in New Mexico, it may prove difficult to establish the deductibility of abnormal or extraordinary expenses and claims.

Allowable deductions also include the following:

- Bequests qualifying for the marital deduction; and
- Charitable gifts.

Code §§ 2055 (charitable deduction), 2056 (marital deduction). A general discussion of each element of allowable deductions follows.

1. *Schedule J – Funeral and Administrative Expenses*

a) <u>Funeral Expenses</u>

Code § 2053 specifically allows the estate to deduct funeral expenses from the gross estate. Code § 2053(a)(1). The Regulations provide further guidance. Funeral expenses are allowable as a deduction if they are (i) actually expended; and (ii) properly allowable as an expense of the estate under local law. Regs. § 20.2053-2. Examples include reasonable expenditures for a tombstone, monument or mausoleum, or for a burial plot, including its future care, and the cost of transportation of the person bringing the body to the place of burial. *Id*. The IRS regularly contests, however, costs associated with memorial services, wakes, family meals after the funeral and similar expenses. *See* Peebles and Janes, 822-2nd T.M., *Estate, Gift, and Generation-Skipping Tax Returns and Audits*, III(J).

Under the New Mexico Uniform Probate Code, "reasonable funeral expenses" are proper expenses of the estate and generally are paid before most other expenses. NMSA § 45-3-805(A)(2). No further detail is provided by the Uniform Probate Code.

Note that the instructions for Schedule J of Form 706, which appear as part of the Form itself, also

[5] Note that the Regulations also refer to the deduction for family-owned business interests, which is no longer available under EGTRRA for deaths after 2003. *See* Code § 2057(j) (terminating the deduction).

require that any reimbursements for funeral expenses be deducted from the claimed amount of expenses. Examples of reimbursements include the death benefits paid by Social Security and the Veteran's Administration.

Funeral expenses are reported on Schedule J of Form 706. Unlike administration expenses, funeral expenses are not deductible on the decedent's last income tax return, or the estate's income tax return.

b) Administration Expenses

Again, Code § 2053 specifically allows the deduction of administration expenses from the gross estate. Code § 2053(a)(2). The Regulations, in a fairly new provision applicable to estates of decedents dying after October 20, 2009 provide further guidance. *See* Regs. § 20.2053-3(e) (effective date). Administration expenses must be actually expended and be necessarily incurred in connection with the collection of assets, the payment of debts and the distribution of the property to the persons entitled to it. *Id*. § 20.2053-3(a). Administration expenses include executor's commissions, attorney's fees and miscellaneous related expenses. *Id*.

Executor commissions must be allowable under local law and be in accordance with "usually accepted standards and practice in estates of similar size and character in the local jurisdiction." Regs. § 20.2053-3(b). The instructions to Schedule J of Form 706 suggest that obtaining a court order as to the amount of executor commissions might be a good idea if an audit is likely. Otherwise, the executor must submit an affidavit supporting the commissions that have not yet been paid as of the date the return is filed with the IRS. The "Estate and Gift Tax Territory Manager" will determine whether the executor's commissions satisfy local law. Note that the same instructions indicate that trustee fees are not deductible as an administration expense of the estate. Rather, such fees are deductible as expenses incurred in administering property not subject to claims on Schedule L.

Attorney's fees also are deductible if they reflect reasonable payment for services rendered, taking into account the nature of the estate, the jurisdiction and the skill and expertise of the attorney. Regs. § 20.2053-3(c). Note that the fees must be related to the proper settlement of the estate. Fees associated with litigation as to the respective interests of the beneficiaries are not deductible, even if the local court approves the fees as an expense of the estate. *Id*. § 20.2053-3(c)(3). If the fees have not been paid as of the date the return is filed, the executor must submit an affidavit stating that the amount has been agreed upon and will be paid. *See* Form 706, Instructions to Schedule J.

Miscellaneous fees include items such as court costs, accountants' fees and appraisers' fees. Regs. § 20.2053-3(d)(1). Expenses associated with selling property, however, are deductible only if the sale was necessary to pay debts, expenses, or taxes, to preserve the estate, or to effect distribution. *Id*. § 20.2053-3(d)(2). The loss on such a sale may also be deductible if the sale was through a "dealer". *Id*. Finally, expenses associated with the defense of claims against the estate are deductible, but only if the expenses are incident to the assertion of a legally recognizable defense. *Id*. § 20.2053-3(d)(3).

Administration expenses also are reported on Schedule J of Form 706. Note that the estate may choose to deduct administration expenses on the estate's income tax return. It may not deduct the expenses on both returns, however.

2. *Schedule K - Debts, Mortgages and Liens*

The deductibility of debts, mortgages and liens is provided by Code § 2053(a)(3), (4). The Code imposes several restrictions on the deductibility of these items, on which the Regulations expound. For example, a claim against the estate based on a contract (other than a charitable pledge) must have been made at arm's length and for full and adequate consideration. Code § 2053(c)(1); *also see* Regs. § 20.2053-4(a)(1). Therefore, the professional completing a Form 706 or determining whether a return is required must pay particular attention to the type of claim against the estate and the various limitations on the deductibility of that claim. Many of the limitations likely will be unfamiliar to practitioners who do not regularly consider the estate tax as many of the applicable regulations only recently became effective for the estates of decedents who died on or after October 20, 2009. *See* Regs. § 20.2053-4(f) (establishing effective date). Individual types of claims will be discussed below.

All debts, mortgages and liens are reported on Schedule K of Form 706.

a) Claims Against the Estate

As mentioned above, the law imposes several restrictions on the deductibility of claims against the estate. In summary, some of the restrictions are:

- The claim must represent a personal obligation of the decedent. Regs. § 20.2053-4(a)(1);
- The claim must have been paid by the estate in satisfaction of the claim. *Id*. § 20.2053-4(a)(1)(i);
- If the claim is not paid by the estate, the claim must be ascertainable with reasonable certainty. *Id*. §§ 20.2053-1(d)(4), 20.2053-4(a)(1)(ii). Contingent or contested claims are not ascertainable with reasonable certainty and are not deductible. *Id*. §§ 20.2053-1(d)(4)(i), 20.2053-4(d)(1);

- The claim must have been enforceable against the estate. *Id*. § 20.2053-4(d)(4); and
- If the claim is for medical expenses, the executor must choose between deducting the expenses on the estate tax return or the decedent's last income tax return, as they cannot be deducted on both. *See* Form 706, Instructions to Schedule J.

b) Charitable Pledges

A charitable pledge is deductible only to the extent that it would be allowed as a charitable deduction under Code § 2055 if it been a bequest. Code § 2053(c)(1)(A); Regs. § 20.2053-5(a)(2).

c) Taxes

Generally speaking, the estate may deduct taxes accrued before the decedent's death. Code § 2053(c)(1)(B); Regs. § 20.2053-6(a). Property taxes, however, are deductible only to the extent the tax is enforceable against the decedent before death. Regs. § 20.2053-6(b). Unpaid gift taxes on gifts made before death also are deductible. *Id*. § 20.2053-6(d). Excise taxes incurred in selling estate assets are deductible, but only if the sale was necessary to pay debts, expenses of administration or taxes, or to preserve the estate, or to effect distribution. *Id*. § 20.2053-6(e). Unpaid income taxes on income earned before death are deductible. *Id*. § 20.2053-6(f). Taxes on income received after death are not, however, deductible. *Id*.

Domestic estate, death or inheritance taxes are not deductible on the estate tax return. Code § 2053(c)(1)(B). Certain foreign death taxes, however, are deductible. *Id*. § 2053(d). An executor considering the deduction for foreign death taxes should proceed with caution. Electing a deduction under section 2053 for foreign death taxes is deemed to be a waiver of the credit for foreign death taxes under Code section 2014. *Id*. § 2053(d)(3)(A).

d) Claims by QTIP Trust Remaindermen

To the extent a remainderman of a QTIP trust has a claim against the surviving spouse, the claim is not deductible. Code § 2053(c)(1)(C). An example would be a claim that the surviving spouse, as trustee of the QTIP trust, breached her fiduciary duty to the remaindermen by making distributions to herself not permitted by the terms of the trust.

e) Unpaid Mortgages and Liens

The estate may deduct the full unpaid amount of a mortgage or lien upon property that is included in the gross estate, assuming the mortgage was entered in a bona fide transaction and for full and adequate consideration. Code § 2053(a)(4); Regs. § 20.2053-7. Interest accrued before the decedent's death also may be deducted. Regs. § 20.2053-7.

3. *Schedule L - Net Losses During Administration and Expenses Incurred in Administering Property not Subject to Claims*

a) Net Losses During Administration

Under Code § 2054, the estate may deduct net losses to property caused by fires, storms, shipwrecks and other casualties, or from theft but only to the extent the estate does not receive reimbursement from insurance. Code § 2054; Regs. § 20.2054-1.

Net losses during administration are reported on Schedule L of Form 706.

b) Expenses incurred in administering property not subject to claims

Technically speaking, expenses associated with administration of property that is not part of the probate estate are not properly deductible as administration expenses. Rather, such expenses are deductible as expenses incurred in administering property not subject to claims under Code § 2053(b). Regs. § 20.2053-8. Generally speaking, as long as the expense would have been deductible if the property was part of the probate estate, the expense also will be deductible under this provision. *See* Regs. § 20.2053-8(b). Note that the "property not subject to claims" must be included in the decedent's gross estate for the expense to be deductible. *Id*. Accordingly, expenses associated with the distribution of a bypass or credit shelter trust upon the death of a surviving spouse would not be deductible. Common examples include expenses paid out of an *inter vivos* revocable trust established by the decedent. While there is no real practical difference, it is interesting to note that both assets in a living trust and held as joint tenants with rights of survivorship (except, in the latter case, real property interests) are subject to claims asserted against the estate of the deceased grantor or joint tenant under the New Mexico Uniform Probate Code. NMSA § 45-6-102.

Expenses incurred in administering property not subject to claims also are reported on Schedule L of Form 706.

4. *Schedule M - Marital Deduction*

Under Code § 2056, the value of property passing from the decedent to his or her surviving spouse is eligible for the marital deduction. Code § 2056(a); Regs. § 20.2056(a)-1(a). Generally speaking, the marital deduction is available if (i) the decedent was survived by a spouse; (ii) the property interest passed from the decedent to the surviving spouse; (iii) the property interest is a deductible interest; and (iv) the executor is able to establish the value of the property interest passing to the surviving spouse. Regs. § 20.2056(a)-1(b). Outright bequests typically qualify

for the marital deduction. It is when the decedent ties strings to the bequest that problems arise in establishing the right to take a marital deduction.

A common example of the type of string a decedent might impose on a bequest to a spouse is to impose a restriction based on time or a contingency that would cause the gift to the spouse to terminate in favor of another person. *See* Code § 2056(b)(1). For example, the decedent may not want his surviving spouse to remarry. If he gives his property to the surviving spouse in trust, subject to termination if she remarries, the gift will not qualify for the marital deduction. *Id*. Typical survival requirements that require the spouse to survive the decedent by 6 months or less do not, however, cause the marital deduction to fail. *Id*. § 2056(b)(3).

Note that a bequest to a non-U.S. citizen spouse, regardless of the spouse's residency status, does not qualify for the marital deduction. Code § 2056(d)(1); Regs. § 20.2056A-1(a). The only way to secure the marital deduction for a gift to a non-U.S. citizen spouse is to establish either a testamentary or a post mortem qualified domestic trust ("QDOT") under Code § 2056A. Qualified domestic trusts are beyond the scope of this paper. As mentioned above, the author has recently presented two papers to the State Bar of Texas (2009 and 2010, respectively) both of which discuss QDOT trusts. He is happy to provide copies of these papers upon request.

Generally speaking, a life estate interest or trust for the benefit of a surviving spouse does not qualify the gift of the underlying property for the marital deduction unless it either also gives the surviving spouse a general power of appointment over the property or qualifies as qualified terminal interest property. *See* Code §§ 2056(b)(5), (6) and (7). A common method of giving property in trust for a surviving spouse is a qualified terminal interest property ("QTIP") trust under section 2056(b)(7).

QTIP trusts have very specific legal requirements for the trust to qualify for the marital deduction. *See* Code § 2056(b)(7); Regs. § 20.2056(b)-7. If the Martial Trust does not qualify for the marital deduction, the trust does not necessarily fail as a trust, but an important aspect is lost and estate taxes will not be deferred until the second death. The legal requirements follow.

a) Beneficiary's Status as the Surviving Spouse

The beneficiary of a QTIP trust must be the surviving spouse of the decedent. Code § 2056(a). The Regulations relating to the estate tax do not provide a definition of spouse. The author also was unable, in a quick review, to locate a definition of "spouse" in other portions of the Regulations relating to the Code. Under general principles of law, therefore, one must look to state law definitions of spouse. New Mexico requires a solemnized marriage. *See* NMSA §§ 40-1-1 through 40-1-3. It also recognizes any marriage conducted outside the state as long as the marriage met the legal requirements of the jurisdiction where the marriage took place. *Id*. § 40-1-4. Therefore, a valid "common law" marriage in Texas will be recognized under New Mexico law despite that there was no marriage ceremony. While the author has not researched the issue, the Federal Defense of Marriage Act likely comes into play with respect to federal taxes, and probably does not allow the marital deduction for same sex spouses who were married in a state that recognizes such unions.

b) Property Passes from the Decedent to the Surviving Spouse

To qualify for the marital deduction, the property in question also must pass from the decedent to the surviving spouse. Code §§ 2056(a), (b)(7)(A)(i), (b)(7)(B)(i)(I). The Regulations found at sections 20.2056(c)-1 and 20.2056(c)-2 provide the IRS's view as to what "passed from the decedent to his surviving spouse" really means. Typically, this requirement is not an issue.

c) The Surviving Spouse Must Be Entitled to Income for Life

To qualify for the marital deduction, the QTIP trust must provide the surviving spouse a "qualified income interest for life". Code § 2056(b)(7)(B). This requirement, in turn, requires that the surviving spouse be entitled to receive all income produced by the trust, payable at least annually for life and that no person (including the Trustee and the surviving spouse) has any power to appoint any part of the trust property to any person other than the surviving spouse. *Id*. § 2056(b)(7)(B)(ii); Regs. § 20.2056(b)-7(d). Fortunately, the Trustee may have the power to distribute principal to the surviving spouse and the spouse may then turn around and give that property to a third person without violating the "no power to appoint" provision. *Id*. § 20.2056(b)-7(d)(6). Ultimately, this means that a QTIP trust can have only one beneficiary and that beneficiary must be the surviving spouse. Again, this is a fairly easy provision to meet.

d) The Executor Must Elect QTIP Status

A QTIP trust will not qualify for the marital deduction unless the executor of the estate of the first spouse to die elects QTIP treatment on that spouse's Form 706. Code § 2056(b)(7). This requirement actually provides an opportunity for post mortem planning. A QTIP trust can be drafted so that it would qualify for the marital deduction and as a bypass or credit shelter trust. If the executor does not elect QTIP status, then the assets in the trust would not be part of

the surviving spouse's estate. The regulations also specifically allow the executor to split a QTIP trust into fractional shares and elect to treat one as a QTIP and the other as a bypass trust, which allows an even greater amount of flexibility for post mortem planning. Regs. § 20.2056-7(b)(1)(ii).

e) Reporting the Marital Deduction Based upon Formula

The claimed marital deduction is reported on Schedule M of Form 706. Many QTIP trusts are funded based upon a formula, which is designed to minimize the amount passing to the QTIP trust. In such a situation, the author typically provides a detailed explanation as to how the marital deduction was calculated. The calculation will involve, depending on the design of the formula, calculations of the property subject to the formula gift, the value of the gift to a bypass/credit shelter trust, and other items as necessary. The author and many practitioners also believe that a protective marital deduction election should be made if the finally determined values of the estate change upon audit. An example of the type of explanation the author provides as part of a Form 706 filing is attached at Appendix A.

5. *Schedule O - Charitable Deductions*

Code § 2055 provides the estate with a deduction for bequests to governmental entities for exclusively public purposes and to charitable entities for exclusively religious, charitable, scientific, literary, or educational purposes. Code § 2055(a); Regs. § 20.2055-1(a). Note that the property given to charity also must be reported as an asset on the appropriate Schedule. The estate also may receive a charitable deduction for gifts of remainder interests in charitable remainder trusts. Code § 2055(e)(2); Regs. § 20.2055-2(a). Conservation easements under Code § 170(h) also may be claimed as a charitable deduction on a Form 706. Code § 2055(f). Note that gifts of art and literary pieces have special rules that must be met to qualify for the deduction. *Id*. § 2055(e)(4).

Charitable bequests of the residue can provide significant complications for calculating the applicable charitable deduction, especially if the testamentary instrument contains boilerplate language requiring that taxes also be paid out of the residue. *See* Code § 2055(c); Regs. § 20.2055-3 (requiring the charitable deduction to be reduced for the amounts not going to charity). The necessary result is that the calculation of the charitable deduction and the estate tax that might be due ends up being a circular formula that must be figured to the end. *See* Regs. § 20.2055-3(a)(2) (recognizing that the amount of the charitable deduction can be obtained only by a series of trial-and-error computations, or by a formula).

Certain administration expenses also must be deducted from the charitable deduction. *See* Regs. § 20.2055-3(b). The Regulations make a distinction between management expenses and transmission expenses when those expenses are paid from the bequest that otherwise would qualify for the charitable deduction. *Id*. "Management expenses" are those connected with the investment of estate assets, or the preservation or maintenance of those assets during a reasonable period of administration. *Id*. § 20.2055-3(b)(1)(i). They can include investment advisory fees, broker commissions and interest. *Id*. "Transmission expenses", on the other hand, are those expenses that would not have otherwise been incurred but for the necessity of collecting assets, paying debts and taxes, and distributing the estate. *Id*. § 20.2055-3(b)(1)(ii). The result of the distinction is that the Regulations require the transmission expenses paid from the bequest to charity to be subtracted from the charitable bequest. *Id*. § 20.2055-3(b)(2). The charitable deduction is further reduced to the extent the estate deducts the charitable share's portion of management expenses under Code § 2053. *Id*. § 20.2055-3(b)(3).

The claimed charitable deduction is reported on Schedule O of Form 706.

6. *State Death Tax Deduction*

The state death tax deduction is available under Code § 2058. It is available to the extent the estate actually paid some amount of "estate, inheritance, legacy, or succession tax" to one of the fifty states or the District of Columbia. The estates of New Mexico residents who did not own property in other states will not be eligible for the deduction because New Mexico currently has no death tax that would be due under current law.[6] New Mexico residents who own property situated in other states, however, may be eligible for the deduction if they are required to pay such taxes because of that property. If the deduction is available, it is reported on the Form 706, Part 1, line 3b.

C. Adjusted Taxable Gifts

To calculate the estate tax, one must add adjusted taxable gifts to the taxable estate. Code § 2001(b). "Adjusted taxable gifts" are the total of all taxable gifts, within the meaning of Code § 2053, made after 1976. *Id*. Taxable gifts in general will be addressed by

[6] New Mexico currently does have an inheritance tax. *See* NMSA 7-7-3 (imposing the inheritance tax). The tax is equal to the maximum federal credit for state death taxes available under Code § 2011. *Id*. §§ 7-7-2(D), 7-7-3(A). EGTRRA, however, amended Code § 2011 such that the state death tax credit is not available for estates of decedents who died after 2004. Because the federal credit is non-existent, the New Mexico estate tax necessarily results in nothing being due.

other speakers. To ensure that the executor does not omit previous gifts from the return, Part 4, Question 7 of the Form 706 seeks information regarding previously filed gift tax returns. Note that if the gift tax returns did not include adequate appraisals disclosing the manner in which the gift was valued, the statute of limitations was never triggered for the IRS to contest the valuation.

D. Applying the Tax Tables

Code § 2001(c) provides the current tax table. As indicated above, the "tentative taxable estate" is determined (gross estate less deductions plus adjusted taxable gifts), one applies the tax tables to determine the tentative tax. Note that the table found at page 4 of the attached Form 706 Instructions is not applicable to estates of decedents dying after December 31, 2009. As of the time this paper was written (mid-April 2011), the IRS had not yet released a Form 706 or Instructions for Form 706 for deaths occurring in 2010. A correct table for deaths after that date, which was obtained from the 2010 Form 709 United States Gift (and Generation-skipping Transfer) Tax Return, follows. *Cf.* Code § 2001(c) (the credit is the same for estate and gift taxes beginning January 1, 2010). Application of the table is fairly straight forward.

Table for Computing Gift Tax

Column A	Column B	Column C	Column D
Taxable amount over	Taxable amount not over—	Tax on amount in Column A	Rate of tax on excess over amount in Column A
------	$10,000	------	18%
$10,000	20,000	$1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	-------	155,800	35%

E. Credits Against the Estate Tax

Code §§ 2012, 2013 and 2014 provide sundry credits against the estate tax, which are only occasionally available to estates. For example, an estate is entitled to a partial credit under Code § 2012 for the amount of gift taxes paid if the gifted property is required to be included in the gross estate under another provision. Section 2013 provides a sliding credit for estate taxes that were paid within the last ten years with respect to property that is included in the decedent's estate. Finally, under section 2014, a credit is available for any foreign death taxes paid out of the estate. The statutes and relevant Regulations should be consulted to calculate the available credit, if any.

V. CONCLUSION

The completion of a Form 706 is no easy task. Almost every question that will be encountered during its preparation will involve a legal question. A full understanding of the federal tax system is therefore a prerequisite to preparing a Form 706. The author hopes the reader will find this paper to be a nice introduction to the topic. The concept of introduction is key. Anyone who attempts to complete a Form 706 must do much more reading to have a full appreciation for its complexity.

APPENDIX A – EXAMPLE OF MARITAL DEDUCTION EXPLANATION

Estate of Mr. H ***-**-****

Schedule M-1 (706) – Calculation of Distribution of Trust Remainder to the H Marital Deduction Trust

A. The Gross Estate. Decedent's gross estate is $4,482,757. (Part 5 – Recapitulation, Item 12.)

B. The Probate Estate. Decedent's probate estate consists of the following items.

ITEM NO.	PROPERTY DESCRIPTION	VALUATION
1	Decedent's one-half community property interest in Items 2 through 7, Schedule C	61,796.
2	Decedent's one-half community property interest in Items 1 through 4, Schedule F	127,465.
Total		189,260.

Pursuant to Article III of the Decedent's Will, all jewelry, household goods, furniture, furnishings and other tangible personal property were given outright to Decedent's spouse. According to Article IV of the Will, the residue of the probate estate was given to the Trustee of the Trust Agreement between Mr. H and Mrs. H, dated April 16, 19** (the "Living Trust"). The residue of the probate estate is calculated as follows:

Gross Probate Estate	189,260.
Less specific gifts to spouse under Art. III of Will (Items 1 through 4, Schedule F)	(127,465.)
Residue of Probate Estate given to Living Trust under Art. IV of Will (Items 2 through 7, Schedule C)	61,796.

C. The Living Trust Estate. The following properties are not included in Decedent's interest in the

Living Trust estate (after receipt of the residuary gift under the Will):

ITEM NO.	PROPERTY DESCRIPTION	VALUATION
1	Decedent's one-half community property interest in Item 1, Schedule C	2,445.
2	Decedent's one-half community property interest in Items 1 and 2, Schedule D	40,808.
3	Decedent's one-half community property interest in Items 1 through 4, Schedule F	127,465.
4	Decedent's one-half community property interest in Items 1 though 17, Schedule I	262,316.
Total		433,034.

The Living Trust Estate is therefore calculated as follows:

Gross Estate	4,482,757.
Less Non-Living Trust Estate	(433,034.)
Living Trust Estate	4,049,723.

D. Pecuniary Distribution to the H Bypass Trust.

Section 4, Paragraph 4.5 of the Living Trust requires distribution of a pecuniary amount equal to the largest amount, if any, which can pass free of federal estate tax by reason of the applicable exclusion amount less (i) all property and interests in property included in Decedent's estate and not passing pursuant to Paragraph 4.5 of the Living Trust which do not qualify for either the marital or charitable deductions for the federal estate tax; (ii) all taxes and administration expenses to be paid by Decedent's estate and/or the Living Trust; and (iii) all other charges to the estate that are not claimed as deductions in the Decedent's estate. The amount of the pecuniary distribution is calculated as follows:

2007 Exclusion Amount	2,000,000.
Less Exclusion Amount used for 2005 Gift (See 2005 Form 709)	(2,811.)
Available Exclusion Amount	1,997,189.
Less other specific and general distributions	(40,808.)
Less administration expenses claimed on Form 706 (Schedule J)	
Funeral Expenses	(2,597.)
Accountant Fees	(7,500.)
Attorney Fees	(25,000.)
Miscellaneous Expenses	(11,453.)
Less debts and administration expenses not claimed on Form 706	0.
Less debts (Schedule K)	(1,117.)
Total Pecuniary Distribution to the H Bypass Trust	1,908,714.

The Executor of Decedent's Estate has therefore allocated the remaining available exclusion amount as follows:

Pecuniary Distribution to the H Bypass Trust (to be funded from a portion of the Living Trust to be determined later)	1,908,714.
Life Insurance Proceeds (Items 1 and 2, Schedule D)	40,808.
Expenses and debts claimed on Form 706 (see Part 5, Line 17)	47,667.
Total Exclusion Amount	1,997,189.

E. Residuary Distribution to the H Marital Deduction Trust.

The Living Trust, Section 4, Paragraph 4.7, requires the Trustee to allocate the Living Trust remainder to the H Marital Deduction Trust. The remainder distribution is calculated as follows:

Living Trust Estate (See Section C of this Schedule M-1)	4,049,723.
Less Pecuniary Distribution to the H Bypass Trust (See Section D of this Schedule M-1)	(1,908,714.)
Less Life Insurance Proceeds (Items 1 and 2, Schedule D)	(40,808.)
Less Expenses Claimed on Form 706 (Schedule J)	(46,550.)
Less Debts (Schedule K)	(1,117.)
Remainder Distribution to the H Marital Deduction Trust	2,052,534.

F. Marital Deduction.

The Executor of Decedent's estate claims the marital deduction for all property listed on Schedules C, D, F, G and I except for property with a pecuniary value of $1,908,714 used to fund the H Bypass Trust, the life insurance proceeds payable (Schedule D) ($40,808), which includes the GST Taxes payable (Schedule R) ($8,443), the funds used to pay the expenses claimed on Form 706 (Schedule J) ($46,550) and the funds to pay the Estate's debts ($1,117). If the value of any asset for which the Executor claims the marital deduction is adjusted for federal estate or gift tax purposes after an examination of this return, the value of the marital deduction claimed shall increase to the amount necessary to produce the optimal marital deduction in Decedent's estate that is necessary to reduce Decedent's taxable estate to zero or as close to zero as possible, excluding assets equal in value to any of Decedent's remaining applicable exclusion amount that were not taxable in Decedent's estate.