# A CLIENT ASKED ME TO PREPARE A FEDERAL ESTATE TAX RETURN
# PSHAW! HOW HARD CAN IT BE?

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## I. OVERVIEW

A. Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return.

1. Form itself is 26(!) pages.

2. With exhibits/attachments, the size of the return can resemble a New York City phone book.

3. Return is signed by fiduciary (executor) and prepared under penalties of perjury.

4. Read the instructions.

B. Return is used to disclose information about a decedent.

1. Assets.

2. Debts.

3. Taxable gifts.

4. Expenses of administration.

5. Beneficiaries.

C. This is a lengthy and complex process and requires A LOT of information and cooperation from the client and third parties.

1. Clients often do not understand the amount of work (and fees) involved in preparing and filing the return.

2. Do yourself (and the client) a favor and start early and be persistent.

D. This is a highly emotional time for the survivors.

1. Grief comes in stages and is often not linear.

2. Conflict among beneficiaries only adds to the difficulties.

3. Above all, be compassionate and patient (but not too patient).

## II. MUST A RETURN BE PREPARED?

A. Not every decedent's estate is required to file a return.

B. Filing threshold:

1. The filing threshold is based on the federal estate tax exemption for the year of death.

2. $12,920,000 for decedents dying in 2023.

3. Expected to be $13,610,000 for decedents dying in 2024.

4. Remember the estate tax exemption "sunset" scheduled for decedents dying after 2025 (exemption will be cut in half).


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C. The filing threshold is not net of debts.

1. Whether a return must be filed depends on the decedent's gross estate, not net estate.

2. For example, assume a decedent owned the following at death:

a. Residence worth $1.5 million.

b. Retirement account worth $2.5 million.

c. Apartment complex worth $9 million and subject to a mortgage of $6 million.

3. The net estate is $7 million, but the gross estate is $13 million, which exceeds the $12,920,000 filing threshold. Therefore, a return must be filed.

D. A return may be required even if the decedent's gross estate does not exceed the filing threshold.

1. A decedent's lifetime taxable gifts are added to the decedent's gross estate to determine whether the filing threshold is exceeded and a return must be filed.

2. For example, assume a decedent owned the following at death:

a. Residence worth $2 million.

b. Retirement account worth $3 million.

c. Business worth $5 million.

3. Assume further the decedent made lifetime taxable gifts (i.e., gifts in excess of the annual gift tax exclusion) totaling $4 million.

4. The gross estate is $10 million, but the gross estate plus lifetime taxable gifts is $14 million, which exceeds the $12,920,000 filing threshold. Therefore, a return must be filed.

5. It is therefore not sufficient to simply determine what assets the decedent owned at the time of death and the value of those assets.

6. The return preparer must determine whether the decedent made any lifetime taxable gifts and, if so, obtain copies of the decedent's gift tax returns (Form 709).

   a. Ideally the decedent and/or return preparer have maintained copies of all filed gift tax returns.

   b. If the decedent filed gift tax returns but you cannot locate them, you can request copies from the IRS by using IRS Form 4506. However, the IRS may only have returns going back six years.

   c. If the decedent made taxable gifts but gift tax returns were not filed, you will need to prepare and file late returns. This may require a thorough review of the decedent's financial records.

## III. SHOULD A RETURN BE PREPARED?

A. Even if not required, there are instances where it is advisable (or highly advisable) to prepare and file a return.

B. The executor or beneficiaries may want to file a return to establish the income tax basis for the decedent's assets, particularly for assets that are difficult to value.

   1. Real estate.

   2. Business interests.

   3. Jewelry, artwork, and collectibles.

C. For a married decedent who leaves a surviving spouse, the surviving spouse may want to file a return to elect "portability."

1. The portability of a deceased spouse's unused exclusion (referred to as "DSUE") is allowed for persons dying on or after January 1, 2011.

2. With portability, any unused estate tax exemption of the first spouse to die can be carried over to and used by the surviving spouse for federal gift and estate tax purposes.

3. A deceased spouse's unused exemption from generation skipping transfer (GST) tax is not subject to portability (i.e., GST exemption is "use it or lose it").

4. A portability election is automatically made by filing the return, unless affirmatively stated otherwise.

5. While portability can provide significant tax savings, there are often no clear-cut formulas or circumstances that give absolute guidance with respect to making the portability election.

6. However, there are a number of relevant factors that should be considered in determining whether to file and elect portability, including:

   a. The size of the decedent's gross estate.

   b. The size of the decedent's DSUE.

   c. The size of the surviving spouse's estate.

   d. The age of the surviving spouse.

   e. The cost of preparing and filing the estate tax return.


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f. The anticipated growth of the decedent's assets and the surviving spouse's assets.

g. Current and anticipated estate, gift, and income tax laws, including the "sunset" of the exemption back to $5 million (as adjusted for inflation) beginning January 1, 2026.

7. Once made, the portability election is irrevocable.

## IV. **<u>HOW IS A RETURN PREPARED?</u>**

A. The return preparer must identify all assets that were owned by the decedent on the decedent's date of death.

1. Persons close to the decedent can be of vital assistance in identifying trust assets.

a. Surviving spouse and other family members.

b. Accountant.

c. Financial advisor.

d. Attorney.

e. Insurance agent.

2. Review the decedent's income tax returns.

3. Go through the decedent's residence.

4. Review the decedent's checkbook.

5. Review the decedent's homeowners and other insurance policies.

6. Determine if the decedent had a safe deposit box.

B. The return preparer must determine the manner in which the decedent owned the assets and report the asset on the correct Schedule of Form 706.

1. Individually.

   a. Schedule A – Real Estate.

   b. Schedule B – Stocks and Bonds.

   c. Schedule C – Mortgages, Notes, and Cash.

   d. Schedule D – Insurance on the Decedent's Life.

   e. Schedule F – Other Miscellaneous Property.

   f. Schedule I – Annuities.

2. Jointly.

   a. Schedule E.

      i. Part 1 – Decedent and spouse only.

      ii. Part 2 – Decedent and all others.

3. In the name of the decedent's revocable trust.

   a. Schedule G.

C. The return preparer must value (or cause to be valued) all assets owned by the decedent.

1. Valuation standard is "fair market value." Treasury Regulation 20.2031-1(b).

   a. "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

   b. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price.

   c. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

2. Cash is the easiest asset to value.

3. Marketable securities are valued by taking the mean (average) of the high and low trading prices on the decedent's date of death.

   a. If the decedent dies on a nontrading day (e.g., weekend or holiday), you average the means for the closest trading days preceding and following date of death.

   b. Accrued interest and dividends are included.

4. Business interests typically require an appraisal.

   a. Revenue Ruling 59-60 outlines the approach, methods, and factors to be considered in valuing stock in a closely-held corporation, including:

      i. History of the company.

      ii. Business of the company.

iii. Financial condition of the company.

iv. Earnings and dividend paying capacities of the company.

b. Appropriate discounts for lack of control and lack of marketability should be considered.

c. An appropriate premium for control should be considered, when applicable.

5. Residential real property values may be supported by using appraised values for property tax purposes.

6. Business real property typically requires an appraisal.

7. Form 712 is required for any policy insuring the decedent's life.

a. This is true regardless of whether the decedent owned the policy.

b. E.g., Form 712 is required for a policy owned by an irrevocable life insurance trust (ILIT) created by the decedent.

c. Review any ILIT to ensure the decedent did not have any "incidents of ownership," otherwise the policy proceeds are included in the decedent's estate notwithstanding the existence of the ILIT.

d. Determine if the decedent transferred any policy within three years of death.

e. Form 712 is also required for any policy owned by the decedent on the life of another.

8. Vehicle values may be supported using Kelly Blue Book, although an appraisal is appropriate for rare or highly valuable vehicles.

9. The IRS has specific rules for valuing tangible personal property, such as furniture, furnishings, clothing, jewelry, artwork, and collectibles (e.g., an appraisal is required for an item of tangible personal property with a value exceeding $3,000).

10. Sale price for any assets sold prior to the filing date may be indicative of value.

11. Special valuation rules may apply where the return is filed solely to elect portability. Treasury Regulation 20.2010-2(a)(7)(ii).

    a. Applies only to property that qualifies for the marital deduction or charitable deduction.

    b. Executor is not required to report a value for each asset that so qualifies.

    c. Instead, the executor is required to (i) exercise due diligence to estimate the total value of all such assets, (ii) report a value for all such assets using ranges provided in the instructions for Form 706, and (iii) provide information necessary to establish the right of the estate to the marital or charitable deduction.

D. Valuation date is the decedent's date of death.

1. You can elect the alternate valuation date if the estate tax liability is reduced as a result.

    a. Alternate valuation date cannot be used if there is no estate tax due (e.g., the estate is under the filing threshold or there is a surviving spouse and the marital deduction eliminates the liability).

    b. Alternate valuation date is six months after the decedent's date of death.

c. Sale price is used for any assets sold after the decedent's date of death and before the alternate valuation date.

E. Funeral expenses.

1. Deductible on Schedule J.

a. Funeral arrangements.

b. Markers.

c. Flowers.

d. Obituary.

F. Administration expenses.

1. Deductible on Schedule J.

2. Generally deductible on Form 706 or Form 1041, but not both.

3. Can estimate executor, attorney, and accountant fees.

4. Appraisal fees.

5. Expenses for the maintenance and protection of estate property.

G. Debts and claims.

1. Debts of the decedent are deductible on Schedule J.

a. Mortgages.

b. Child support.

c. Alimony.

2. Claims against the decedent are deductible on Schedule J.

a. Litigation (how to value?)

b. Personal guarantee (how to value?)

H. Marital bequests.

1. Bequests to the decedent's spouse are deductible on Schedule M.

a. Outright bequests.

b. Qualified terminable interest property (QTIP) if a QTIP election is made.

c. Special rules apply if the surviving spouse is not a United States citizen and a qualified domestic trust (QDOT) is needed.

I. Charitable bequests.

1. Bequests to charities are deductible on Schedule O.

a. Ensure the entity is a qualifying charity.

J. Generation-Skipping Transfer Tax (GST).

1. Bequests to "skip persons" (e.g., grandchildren) are reported on Schedule R.

a. Decedent's remaining GST exemption is allocated.

b. Reverse QTIP election can be made.

c. Distinguish between direct skips and indirect skips.

K. Attachments.

1. Death certificate.

2. Will.

3. Revocable trust.

4. Any irrevocable trusts.

5. Valuations must be substantiated.

a. Statements for bank accounts.

b. Statements for brokerage and retirement accounts.

c. Appraisals.

L. Miscellaneous forms.

1. Form 56.

a. Notifies the IRS of a fiduciary relationship and information about the fiduciary (e.g., executor of a decedent's estate).

2. Form 2848.

a. Power of attorney that authorizes the IRS to deal with a taxpayer's appointed agent.

3. Form 8971.

a. Provides information to beneficiaries regarding the income tax basis of the decedent's assets.

b. Due 30 days after the due date for the return, including extensions.

4. Form 4810.

   a. Request for prompt assessment of taxes due.

5. Form 5495.

   a. Request for discharge of fiduciary from personal liability for taxes.

M. Due date.

1. The return is due nine months after the decedent's date of death.

2. An automatic six-month extension can be obtained by filing Form 4768.

   a. This extends the time to file the return.

   b. It DOES NOT extend the time to pay any estate tax due.

3. Special rules may apply where the return is filed solely to elect portability. Revenue Procedure 2022-32.

   a. The return can be filed up to the fifth anniversary of the decedent's date of death.

   b. The executor must state at the top of the return that it is "filed pursuant to Rev. Proc. 2022-32 to elect portability under § 2010(c)(5)(A)."

   c. If it is subsequently determined that an estate tax return was required under Code Section 6018(a), based on the value of the gross estate and taxable gifts, the extension will be deemed null and void ab initio (i.e., the return will be deemed late).

4. Late returns.

   a. Failure to file penalty.

   b. Failure to pay penalty.

N. Closing letter.

1. From a trust administration perspective, it is important to know when the IRS has completed its review of the return.

2. Not automatically sent. Need to affirmatively request.

3. Alternatively, the account transcript can be accessed online.