ESTATE PLANNING ISSUES & UPDATES

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ESTATE PLANNING ISSUES & UPDATES

CHAPTER 1

INTRODUCTION 1-1
ESTATE TAX LAW AND OTHER ISSUES 1-2
A. The Past & Current Estate/GST/Gift Tax Environment 1-2
Possible Scenarios 1-2
B. How the Estate Tax Was Repealed 1-3
C. 2012 Transfer Tax Rules 1-5
Percent of People Paying an Estate Tax 1-5
Baby Boomers 1-5
Recurring Questions for the Coming Years 1-6
The Decade (+) in Review 1-6
Alternate Estate Tax Proposals 1-7
WHY 2012 IS SO IMPORANT FOR CLIENTS TO REVIEW THEIR ESTATE PLANS 1-7
A. National Estate Planning Awareness Week 1-7
B. Importance of Review of Estate Plan 1-9
C. Team Approach to Estate Planning 1-10
ADVISOR'S REVIEW OF CLIENT'S ESTATE PLAN 1-10
A. Determine if Clients are U.S. Residents and Citizens of the U.S. 1-10
B. Statement of Domicile 1-12
C. Trust Situs 1-13
D. Specific Bequests 1-13
E. Charitable Bequests 1-14
F. Review Section 529 College Savings Plan 1-15
G. Life Insurance 1-15
H. Tax Apportionment 1-17
Equitable Proration 1-17
Right of Reimbursement 1-18
Determine Client's Wishes 1-19
I. Review Retirement Plans 1-20
J. State Tax Changes 1-20
K. Succession Planning 1-21
L. Alternate Valuation Date 1-21
M. Stale Trusts 1-21
TRUE STORIES THAT ENDED BADLY 1-22

CHAPTER 2

TRUST ADMINISTRATION 2-1
Administrative Issues Determined in the Estate Plan 2-2
Trust Litigation is on the Rise 2-3

Organization & Coordination 2-3
The Importance of an Approach in All Trust Administration 2-3
I. TRUST ADMINISTRATION WITH MARRIED CLIENTS. 2-5
Estate Documents for Spouses and State Law 2-6
Assumptions Used During Trust Administration 2-6
Immediate Creation or Pass-Through Approach 2-6
Reasons for Delay in Funding the Subtrusts 2-7
The Administrative Trust 2-7
The Advantages of an Administrative Trust 2-8
Practical Considerations 2-9
Mechanics for Establishing the Administrative Trust 2-9
Entitlement to Income During Term of Administrative Trust 2-10
The Trustee of the Administrative Trust 2-10
Creative Uses of the Administrative Trust 2-10
Important Tax Tools of Spousal Estate Planning 2-11
The Lifetime Exclusion. 2-11
The Unlimited Marital Deduction 2-11
The Marital Deduction 2-11
Requirements for All Marital Deduction Gifts 2-12
II. COMMON ESTATE PLANS INVOLVING SPOUSES 2-12
The Single Fund Revocable Living Trust 2-12
The Concept of Portability and the Relief Provided by Portability 2-13
Required Portability Election on Estate Tax Return 2-14
Conforming Amendments 2-14
Lifetime Gifting Options Under Portability 2-14
Income Tax Advantages with Portability 2-15
Disadvantages of Portability 2-15
Drafting Documents to Incorporate Portability 2-16
The Creation of Subtrusts 2-16
The Survivor's Share 2-16
The Bypass (Exemption/Credit Shelter) Trust 2-17
Trustee of the Bypass Trust 2-17
Beneficiaries of the Bypass Trust 2-17
Distributions from the Bypass Trust 2-18
On the Death of the Surviving Spouse 2-18
Single Fund Trust with Disclaimer Provision 2-19
The Two-Subtrust (A/B Trusts) 2-20
The Three (or more) Subtrust Format (A/B/C Trusts) 2-21
Trusts that Qualify for the Marital Deduction – The Marital Deduction Trust 2-21
The QTIP Trust 2-21
Spouse's Qualifying Income Interest in the QTIP 2-22
Distribution of Principal to the Surviving Spouse from the QTIP 2-23
Termination of Marital Trust at Death of Surviving Spouse 2-23
Pourover of Subtrusts into Bypass Trust 2-23
The QTIPable Bypass Trust (Clayton Trusts) 2-24

III. FUNDING FORMULA CLAUSES & THE DEATH OF THE FIRST SPOUSE 2-25
The Choice of the Funding Formula 2-25
Factors Influencing the Funding Choice 2-25
Types of Funding Formula Clauses 2-26
THE PECUNIARY BEQUEST FORMULA 2-26
The Pecuniary Marital with a Residual Bypass 2-26
The Valuation Options Used with the Pecuniary/Residual Funding Formula 2-27
1. "True Worth" Method and the Pecuniary/Residual Formula 2-28
2. Fairly Representative Method and the Reserve Pecuniary Formula 2-28
3. "Minimum Worth" Funding 2-29
Reverse Pecuniary Formula – Pecuniary Bypass/Residual Marital 2-29
The Pecuniary Bypass (Reverse Pecuniary) with a Residual Marital 2-29
Valuation Options Used with Reverse Pecuniary Formula 2-30
THE FRACTIONAL SHARE FORMULA 2-30
Traditional (Strict) Fractional Share Formula 2-31
Non-pro rata Fractional Formula (Pick & Choose) 2-32
Review Formula Clauses – Switch from Pecuniary/Residual to Fractional Share or Change Valuation Option 2-32
The Exempt and Non-Exempt GST Subtrust 2-33
IV. ECONOMIC IMPACT OF FORMULA CLAUSES (Using 2010 Rules) COMPARISON CHARTS RE MARITAL DEDUCTION FORMULA 2-34
EXAMPLE 1 2-34
EXAMPLE 2 2-34
Economic Impact of Funding Formula Clauses Where Assets Depreciate During Administration 2-35
EXAMPLE 1 2-35
A. Pecuniary Marital Formula 2-35
B. Pecuniary Bypass Formula 2-36
C. Fairly Representative Formula 2-36
D. Fractional Share Formula 2-37
Economic Impact of Funding Formula Clauses Where Assets Appreciate During Administration 2-37
EXAMPLE 2 2-37
A. Pecuniary Marital Formula 2-37
B. Pecuniary Bypass Formula 2-38
C. Fairly Representative Formula 2-38
D. Fractional Share Formula 2-39
V. SPECIAL ISSUES WITH FORMULA CLAUSES 2-39
Does the Formula Still Work 2-39
The Story of Herb & Edith 2-40
The Story of John & Alice 2-40
SPECIAL INCOME TAX RULES RELATED TO SUBTRUST FUNDING 2-41
Calculate the Gain or Loss on Funding the Pecuniary Share 2-41
Funding Pecuniary Share with Depreciated Property 2-42

Distributions to the Subtrusts Carry Out DNI 2-42
Conclusion 2-43

CHAPTER 3

FAMILY LAW AND OTHER ISSUES 3-1
A. Change in Family Status 3-1
B. Blended Families 3-1
C. Selection of Guardian 3-1
D. Designation of Executor or Successor Trustee 3-3
E. Divorce & Family Law Issues 3-4
Family Support Obligations 3-5
Determining the Character of Property 3-6
Post-Nuptial Transmutation/Marital Property Agreements 3-6
The Poorer Spouse's Bypass Trust 3-8
Example (Assume constant 2009 Estate Tax Rates and Exclusions) 3-8
Example 3-9

CHAPTER 4

CALIFORNIA ISSUES AND UPDATES 4-1
A. Disinheritance Clauses 4-1
Disinheritance of the Spouse 4-2
B. California's No-Contest Legislation 4-3
What Constitutes a Contest After January 1, 2010 4-4
C. Amendments to Uniform Principal and Income Act 4-7
Fiduciary Accounting for Partnership Assets Held by Trust Under
Pre- and Post- 2000 Uniform Principal & Income Act 4-7
Facts 4-7
Issues 4-7
1. How does the trustee account for the partnership's income and
Loss in 1998 under CA Prob. C Sec. 16308? 4-7
2. How does such accounting impact the financial and income
Tax situation to the trust as well as the income and remainder
Beneficiaries? 4-7
3. How does the trustee account for the same information in 2000
Under CA Prob. C Secs. 16350? 4-7
Accounting for Partnership Interests Held by Estates and Trusts 4-7
Background for Former CA Prob. C Sec. 16308 4-8
CA Prob. C Sec. 16350 4-10
Comparison of Old and New Law 4-10
Update on Distributions from Entities 4-11

Schedule B – Form 1041 4-12
Algebraic Formula Adopted by NCCUSL in 2008 4-13
Sec. 16361/UPIA Sec. 409 2008 Amendment 4-14
Non-Marital Trust 4-15
Marital Trust 4-15
UPIA Sec. 16361/409(f) – The Trustee will determine the internal Income of each separate fund 4-17
UPIA Sec. 16361/409(g) – if the trustee cannot determine the Internal income of a separate fund but can determine the value of the Separate fund, the internal income is deemed to be (insert number Between 3-5%) of the fund's value 4-18
Retroactivity of the Amendment 4-18

CHAPTER 5

SPECIAL ADMINISTRATIVE ISSUES IN RECESSIONARY TIMES 5-1
A. Characteristics of the Current Recession 5-1
B. Insolvency Issues and Creditors vs. Beneficiaries 5-1
C. Illiquidity Issues 5-3
Lack of Income Productivity from Specific or General Pecuniary Devises 5-3
Timely Payment of Pecuniary Bequests. 5-3
Payment of Debts, Expenses & Taxes 5-4
D. Valuation of Assets for Purposes of Distribution 5-5
Example 5-5
Satisfying Devices with In-Kind Distribution of Property 5-6
Sale of Residuary Assets to Pay Expenses of Administration, Taxes and Debt 5-6
E. Abatement of Gifts 5-7

CHAPTER 6

1. REVIEW CHECKLIST 6-2
2. CLIENT QUESTIONNAIRE 6-5
3. ESTATE PLANNING SELF-ASSESSMENT 6-12
4. CLIENT FINANCIAL ORGANIZER 6-13

CHAPTER 7

SUGGESTED GIFTING STRATEGIES 7-1
PLANNING IN THE "PERFECT STORM" – LOW VALUES, LOW INTEREST RATES, CHANGE ON THE WAY 7-1
A. Loans to Family Members 7-1

B. Consider a Variety of Estate Freezing Transactions Installment Sales 7-2
Grantor Retained Annuity Trust (GRAT) 7-2
Qualified Personal Residence Trust (QPRT 7-3
The Installment Sale 7-3
Advantages of the Installment Sale 7-3
IRC Sec. 267 Related Party Rules 7-4
IRC Sec. 1239 Rules 7-4
IRC Sec. 453(g) 7-5
Like kind Exchanges & Related Parties 7-5
Disposition of Installment Note at Death 7-5
Installment Note as IRD 7-6
THE INSTALLMENT SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT) 7-6
Benefits of a Grantor Trust 7-7
Example 7-7
Benefits of Sales Transaction to IDGT 7-7
Variations on Sales Transaction Involving an IDGT 7-9
a. Replace the Installment Sale With a Self-Canceling Installment Note (SCIN) 7-9
Elements to Include in a SCIN 7-9
The Income Tax Issues in a SCIN 7-10
Using a SCIN Sale to an IDGT 7-11
b. Replace the Installment Note with a Private Annuity Sale to an IDGT 7-11
Private Annuity Review 7-11
Exclusion from Estate Taxes 7-12
Gift Tax Considerations 7-12
Income Tax Considerations 7-13
Pre-October 18, 2006 7-13
Post-October 18, 2006 7-13
Adjusted Basis 7-14
Downside to Annuity Strategy 7-14
Case Law and the Private Annuity 7-15
Adequate Capitalization of Obligor 7-16
Private Annuity Sale to IDGT 7-16
The Exhaustion Test 7-17
Gifting the Installment Note from the IDGT to Charity 7-18
ADDING A CHARITABLE COMPONENT TO THE ESTATE PLAN 7-18
Income Tax Deduction on Gift of Remainder Interest in Personal Residence 7-18
Income Tax Deduction 7-19
The Estate Tax Consequences on the Death of the Grantor/Second Spouse 7-19
The Adjusted Basis of the Residence at Various Points in Strategy 7-22
The Necessary Components of the Life Estate Agreement 7-23
Property Tax Issues 7-23
Conclusion 7-23
Charitable Lead Trust (CLT) 7-23

Required Terms of a CLT....7-24
Charitable Lead Annuity Trust (CLAT)....7-25
Charitable Lead Unitrust (CLUT)....7-25
Other CLT Requirements....7-25
Grantor vs. Non-Grantor CLT....7-26
Available Tax Deductions....7-26
Recapture Issues....7-26
GST Issues in CLTs....7-27
Shark Fin CLAT....7-27

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ESTATE PLANNING ISSUES & UPDATES

CHAPTER 1

INTRODUCTION

This is a one-day seminar that covers various selected topics that reflect the crucial role that advisors play in the estate planning process. Whether the client has an estate plan in place or needs to create one, an advisor can greatly assist the client with its review or the execution. A client's estate plan is usually as simple or complex as that client's life, but the changes in the law during the past few years have made even the simplest plan more complicated and now there is an even wider range of complexity in this area depending on the complexities in the grantor's life or his or her assets.

Besides uncertainty in the law, the economy has been unbelievably challenging for the past several years. However this can create opportunities in the estate planning arena that clients may find both useful and interesting. They include:

a. The theory that tough times are good times to trim estates. Some stocks and bonds are down, real estate and other assets have tumbled, retirement plans and 529 plans are substantially reduced, and interest rates are at record lows.

b. The transfer tax exemptions are the largest in its history until 12/31/2012 at $5,120,000 with a top tax rate of 35% but will revert to the 2001 rules that include a $1,000,000 exemption (with $1,000,000 indexed GST exemption) and a 55% tax rate.

c. The tax laws are in a state of flux and some favorable strategies may be curtailed or removed by additional legislation.

Therefore estate planning opportunities should be presented to clients before year end to allow them to take advantage of the positive aspects of this current environment. It's also a good time to review clients' estate plans to ensure that their plans continue to carrying out their objectives.

ESTATE TAX LAW AND OTHER ISSUES.

A. The Past & Current Estate/GST/Gift Tax Environment

a. Because Congress did not act in 2009 to preserve the federal estate and GST transfer taxes in 2010, they were repealed on 1/1/2010 as a result of legislation passed (EGTRRA) in 2001.

b. Under EGTRRA, the transfer taxes were repealed for one year and reinstated on 1/1/2011 at the 2002 $1.0M exclusion (estate and indexed GST) and 55% rate with a 5% surtax on estates between $10M and $17,184M.

c. On December 17, 2010, legislation was finally passed that restored the transfer tax regime retroactive to January 1, 2010 with an exemption of $5,000,000 (for all transfer taxes), a top tax rate of 35% and the creation of portability. Additionally, for decedents dying in 2010, an election to "opt out" of this regime was available with no estate or GST tax and modified carryover basis.

(i) Modified carryover basis under IRC Sec. 1022 replaced the IRC Sec. 1014 provisions which were in effect for prior years and continues to be the law.

d. The 2010 legislation is set to expire on December 31, 2012 and once again the law will revert to 2001 EGTRRA.

e. Uncertainty exists once more as to what Congress will do in terms of legislation and the effective date of such legislation (if it occurs). We continue in a very changed and unpredictable environment, and clients and their advisors face significant uncertainty in planning for gift transfers during life or at death.

f. The $4.0 million dollar question is whether "clawback" will occur.

Possible Scenarios:

a. Congress could enact legislation retroactive to 1/1/13 and either extend the 2010 law or enact new rates and exemptions;

b. Congress could enact legislation effective on the date of enactment that either extends the 2010 law or enacts new rates and exemptions.

c. Congress could continue the deadlock and not enact any legislation so the current reversion to 2001 law would take in effect beginning January, 1, 2013 with a return to the former 2002 rates and exclusions.

(i) Plans based on formula clauses or decisions tied to estate taxes may be significantly impacted by the current state of flux.

(ii) We will discuss the benefits and burdens of marital formula clauses.

(iii) Problems exist with both children and grandchildren for GST.

d. Will Congress quickly clear up the uncertainty or wait? Remember that someone dying on 1/1/13 doesn't have an estate tax return due until March, 2014 (if extended).

e. We have to be careful in taking advantage of strategies based on current law and a gift tax rate of 35% (versus 45% or 55%) because of the possibility of "clawback" issues.

B. <u>How the Estate Tax Was Repealed</u>

a. When the 2001 legislation was passed, economists were forecasting budget surpluses over the coming decade of several trillion dollars, and EGTRRA undertook to return that surplus back to the taxpayers in the form of approximately $1.3trillion in tax cuts spread throughout the decade.

b. The tax cuts included a phased increase in the applicable exclusion amount from $675K to $3.5M, a phased reduction in tax rate from 55% to 45%, a phase out of the state tax credit and similar changes to the gift and GST rates and rules.

c. The big change was modified carryover basis which is the lesser of the decedent's adjusted basis in the property or its FMV at the date of death. The concept was that capital gains on actual dispositions would replace the estate/GST tax which is based on assets' values at transfer.

d. To replace the applicable exemption amount, there would be allowed $1.3M in step up to anyone ('aggregate basis adjustment") and an additional $3.0M step up "spousal basis adjustment" to a surviving spouse. Both of these adjustments would be indexed for inflation.

e. The reason for the "repeal of repeal" in 2011 was the "Byrd Rule" which is a 1985 amendment of the Congressional Budget Act sponsored by Senator Robert Byrd that makes it "out of order" in the Senate to include "extraneous" provisions

in budget reconciliation. "Extraneous" is defined to include the reduction of tax receipts beyond the period provided for in the Congressional Budget Resolution. Because the 2001 budget resolution covered 10 years, it would have been "out of order" to reduce taxes beyond the tenth year. The Byrd Rule could have been waived by a vote of 60 Senators but those votes were not available in 2001 as the Conference vote was 58-33.

f. While the end result that occurred on January 1, 2010 has proven to be preposterous, the historical components viewed separately are somewhat more understandable.

(i) The 2001 tax cuts were tied to ten years of projected surpluses which obviously did not occur.

(ii) In 2005, the House passed a permanent repeal bill that was to come up for debate in the Senate just as Hurricane Katrina hit.

(iii) In 2006, the Senate tried to get a bill passed but failed to attract more than 58 votes.

(iv) On 12/2/2009, the House passed HR 4154 that permanently established a $3.5M exemption and a 45% tax rate. Not one republican voted for the bill and 26 Democrats voted against it. Those against it wanted permanent repeal or a larger exemption and lower tax rate.

(v) The Senate was preoccupied with health care reform and the conflict between Max Baucus and Mitch McConnell stalled any bill being passed before the end of 2009.

g. The tax bill in late 2010 was a compromise most likely based on the number of billionaires that died in 2010 whose families clearly had the resources to fight the constitutional issue of retroactive legislation. The compromise was the 2010, one-year "opt out" election, to compensate for the length of time it took Congress to hammer out a bill. Once again, this was a temporary fix for two years and we are now on the brink of this round of legislation expiring and the transfer tax law returning to those of 2002. Because this is an election year, it is doubtful that anything will be done before the election or even year. The chaos continues!

C. 2012 Transfer Tax Rules.

a. Exemption Amount – Effective Jan. 1, 2010, the federal estate tax exemption was increased from $3.5 million to $5.0 million per decedent. It increased on January 1, 2012 to $5,120,000. This means that an individual can transfer $5.12 million free of federal gift, estate and GST tax and married couples can transfer $10.24 million. Until the end of the year, the gift, estate and GST taxes are unified once again.

b. Tax Rates – the 2012 top rate is 35%. Under the current law, the rate is set to reapply after 2012 to the former rate of 55% with a surcharge on large estates.

c. New Annual Gift Rules – the annual gift exclusion amount for 2012 is $13,000 per beneficiary for present interest gifts. Gifts to citizen-spouses are allowed without limit. Gifts to non-citizen-spouses are capped at $139,000 for 2012.

d. Lifetime Gift Exemption - The lifetime gift tax exemption amount is $ 5,120,000, with taxable gifts taxed at a maximum rate of 35% if the law continues or 55% in excess of $1.0 million if the estate tax laws revert to 2001.

e. New Terms and Portability – The Applicable Exclusion Amount is now comprised of the Basic Exclusion ($5,120,000 in 2012) and the Deceased Spouse's Unused Exclusion Amount (DSUEA). Portability came into effect in 2011 and will expire unless extended on 12/31/2012.

Percent of People Paying an Estate Tax

In 2006 when the federal estate tax exemption was $2 million, there were only 22,624 estates that owed an estate tax. The increased exemption amount to $3.5M removed 90% of the population from paying estate taxes and reduced the revenue lost by one-half. Estimates suggest that in 2009 approximately 33,500 estates filed returns but fewer than half, or 14,700 actually paid any tax. Estate tax liability totaled $20.6 billion in 2009 The projection for 2011 if the filing of 8,600 estate tax returns with only 3,300 owing any estate tax projected at $10.6 billion.

Baby Boomers

It must be remembered, however, that Baby Boomers are heading into retirement and have (or will) become the recipient from their parents in the Great Generation of one of the

largest intergenerational transfers of wealth. So the number of estate tax returns may increase dramatically, but it has yet to be seen how the Great Recession has impacted this.

Recurring Questions for the Coming Years

a. Resolution of the 2010 tax law uncertainty issues as 12/31/2012 occurs – where are we going?

b. What will the law ultimately be for 2013?

c. What if a client dies in 2013?

d. Consider defensive planning actions in 2012?

(i) Utilize the generous basic exclusion amount for gifts before year end.

(ii) Use self settled dynasty trusts so that the client can remove assets from their estate but remain a beneficiary.

(iii) Use grantor trusts with special provisions or a toggle switch. If the estate tax were actually repealed, the client's requirement as grantor to pay income tax can be toggled off. If not, it can remain on to reduce the estate.

The Decade (+) in Review

Estate planning has been almost surreal for the past twelve years:

a. The estate and GST tax were repealed in 2001 but effective in 2010 and then for only one year leaving planners and their clients in great uncertainty;

b. Additionally, the prior administration and a good portion of Congress tried and continue to try very hard to permanently repeal the estate and GST tax;

c. Practitioners have been continually developing methods to minimize these taxes:

d. The IRS and the tax courts have been actively challenging these minimization techniques; and

e. 2010 and 2011 came and went and temporary legislation was enacted only to expire on 12/31/2012;

f. Many things have transpired since the 2001 law was enacted that make estate tax repeal economically impossible.

However, the transfer tax rate (whether at 35% - 55%) is still too high and planners will continue to develop strategies for wealthier clients until it is reduced to a reasonable level.

Alternate Estate Tax Proposals:

a. Maintain the current rules under the 2010 legislation with unification, an exclusion of $5,120,000, a 35% tax rate and portability;

b. Revert back to the applicable exemption amount at $3.5 M with 45% tax rate;

c. Maintain the unification of the gift and estate tax;

d. Restore the state tax credit;

e. Enact portability of the spousal credit amount permanently;

f. Eliminate crummy withdrawal rights; and/or

g. Eliminate non-business valuation discounts; e.g. the Pomeroy bill which called for the elimination of discounts on passive assets.

h. Disallow short-term GRATs. (actually passed by the House)

i. Allow the estate tax law return to pre-2001 with an applicable exemption of $1.0M and a rate of 55%.

j. Extend the current rules for 2010 and go back to pre-2009 exemption of $2.0M with a 46% rate.

WHY 2012 IS SO IMPORTANT FOR CLIENTS TO REVIEW THEIR ESTATE PLANS

A. National Estate Planning Awareness Week.

a. Congress has designated by resolution that the third week of each October be designated in perpetuity as "National Estate Planning Awareness Week".

b. H. Res. 1499 stated that an estimated 120,000,000 Americans do not have up-to date estate plans to protect themselves or their families in the event of sickness, accidents or untimely death.

c. Additionally those that have estate plans do not have them reviewed periodically and updated.

d. Provisions including spousal formula clauses are often used to automatically contract or expand with the economic times. But sometimes the provisions become outdated either because of a change in law, a change in the family structure or a change in personal circumstances. Sometimes new techniques and strategies are created that weren't available when the plan was first executed.

e. A disturbing 2004 Roper poll commissioned by the AICPA found that 2/3 of Americans over the age of 65 believed they lacked the knowledge necessary to adequately plan for retirement and nearly one-half of all Americans are unfamiliar with basic retirement tools such as a401(k) plan.

f. Careful estate planning can greatly assist Americans in preserving assets built over a lifetime for the benefit of family, friends, heirs and charity.

g. Estate planning is a vast area and involves many considerations that include:

(i) Safekeeping of important documents;

(ii) Documentation of assets;

(iii) Operation of state law;

(iv) Preparation of legal instruments;

(v) Acquiring and understanding insurance tools;

(vi) Availability of trust arrangements;

(vii) Charitable giving;

(viii) Inter vivos care of the grantor; and

(ix) Other important factors.

h. Important decisions made during the estate planning process include:

a. Method of holding title to assets;

b. Designation of beneficiaries; and

c. Lifetime transfer of assets.

i. Careful estate planning can prevent family members or other beneficiaries from being subjected to complex legal and administrative processes requiring significant expenditure of time, and can greatly reduce confusion or even animosity among family members or other heirs upon the death of a loved one.

j. The implementation of an estate plan starts with sound education and planning, and then requires the proper drafting and execution of appropriate legal documents, including wills, trusts, durable powers of attorney for health care and financial management.

B. Importance of Review of Estate Plan.

a. The client may or may not know that his/he/their estate plan is outdated and needs to be revised. Clients don't particularly enjoy the estate planning process because it is a fairly sobering experience and they may need some encouragement from their advisors. But the bottom line remains that if clients don't revisit their estate plan periodically, it will unlikely continue to accomplish their goals.

b. Incentives for annual meetings include:

(i) Coordination of all advisers can help protect clients from Madoff and other similar situations;

(ii) Regular reviews to assure that corporate minutes, trust Crummey powers and other formalities are dealt with;

(iii) The fact that it is much less costly from both a fee and result perspective to keep planning current then to wait for years until problems become more costly and perhaps difficult to untangle; and

(iv) The premise that the grantor's intent is the primary authority in estate planning so it is essential that the documents clearly reflect the client's current objectives and wishes regarding the disposition of assets. While the Will or the Living Trust may be the center piece of a client's estate plan, it is important to collect and review all other documents that impact transfers at death. This would include:

- Insurance & Retirement Plans & Beneficiary Designations;
- Shareholder, Partnerships or LLC's agreements;
- Buy Sell Agreements;
- Real Estate Transfer Documents;
- Marital Property Agreements/ Pre Nuptial Agreements;
- Investment Policy Statements;
- Trust Agreements;
- Health Care Documents;
- Powers of Attorney for Financial Management; (Caution: For many clients the powers of attorney, not the will or living trust, may prove the most significant dispositive document.)
- HIPAA Releases.

C. Team Approach to Estate Planning

a. Communication among advisors is very important, but often absent. Accountants and financial advisors often have ongoing dealings with the clients long after the estate plan has been drafted by the attorney. It's a team effort to keep the lines of communication open to make sure that the plan gets updated and stays on course.

b. Don't just take the client's word for it. Be sure to dig deeper than what the client tells you about his /her/their assets. Sometimes clients don't understand precise terms and get mixed up about their holdings and about "title" to assets in particular. Request a copy of the documents for your files. What is often discovered by the advisor doing post mortem administration is that a client has sporadically created the pieces of the estate plan.

c. We must overcome the perception held by some of our clients that:

(i) The increase in the exemption amount reduces the need for estate planning; and/ or

(i) That no administration needs to be done on the death of the first spouse.

Advisor's Review of Client's Estate Plan.

What should the advisor look for in the review of wills and other documents? Through the tax preparation process, the CPA often has access to the information statements and other valuable information that provides information about the client's property. This includes how property is titled. Often the estate planning attorney thinks that all the assets have been transferred into the revocable trust and only finds out after a death that the transfer either has not happened or that the property was subsequently transferred out of the trust. This can cause time consuming, administrative problems. The investment and insurance advisors also have ongoing and valuable information.

A. Determine if Clients are U.S. Residents and Citizens of the U.S.

a. It is no secret that increasing globalization with improved communications and technology means that more and more practitioners will encounter clients with international issues.

b. This is true in the estate planning arena. A practitioner does not have to practice international estate planning to encounter international issues and the inability to recognize these international issues can result in substantial risk to both clients and practitioners.

c. Nothing can be taken for granted and facts should never be assumed. Practitioners need to gather much more information than they might be accustomed to doing to thoroughly identify potential international issues their clients may be facing.

d. Understanding "Terms of Art" in this area is very important as some terms have different meanings for different purposes;

(i) The term "residence" has different meanings for immigration law purposes and income tax purposes;

(ii) "Residence" differs from "domicile" which is a term for estate and gift tax purposes;

(iii) And a resident for income tax purposes may not be domiciled in the US for estate and gift tax (transfer tax) purposes.

e. Determination of Residence – Practitioners must determine the client's residence in order to determine the proper structure of the estate plan and how the transfer tax laws apply especially in the spousal situation.

f. <u>Marital Deduction</u> – Transfers to non-US citizen spouses do not qualify for the marital deduction unless special requirements are met in the way of the QDOT trust (Qualified Domestic Trust). A QDOT trust is a marital trust with strings attached to ensure that the assets will be taxed on the death of the non-citizen surviving spouse.

(i) Remember that these rules come into play only for assets that exceed the decedent's Applicable Exclusion Amount (under IRC Sec. 2010). With an exemption of $5.12 million, only decedents' estates in excess of $5.12 M with non-citizen spouses will need to be concerned about these rules. But if the $5.12 M contracts to somewhere between $3.5 to $1.0 M, the number of estates that will be affected will increase.

(ii) There are several alternatives to a QDOT trust established by the deceased spouse. One alternative permits the deceased spouse's executor or the surviving spouse to establish a QDOT trust that is funded with assets passing directly to the surviving spouse that the surviving spouse transfers or irrevocably assigns to the QDOT trust. Using irrevocable assignments, retirement benefits and other property passing directly to a noncitizen

surviving spouse may qualify for QDOT treatment under IRC Sec. 2056(d)(2)(B); Treas. Reg Sec. 20.2056A-4(b).

(iii) If the surviving spouse becomes a United States citizen before the filing of the estate tax return, the spouse is treated as a United States citizen as of the deceased spouse's date of death as long as the surviving spouse was a U.S. domiciliary at all times between the deceased spouse's date of death and the date of becoming a United States citizen.

g. Inter Vivos Gift Transfers – If the donee spouse is not a US citizen the unlimited gift-tax marital deduction is not allowed for transfers to that spouse; however, the annual exclusion allowable in the case of transfers to a qualified spouse is $139,000 in 2012 (versus the $13,000).

h. Foreign Trusts – Since the mid-1990's, the US has enacted important legislation about the taxation of foreign trusts and report of information with respect to those trusts.

(i) Example - U.S. citizen establishes a revocable trust under the law of CA and transfers to that trust U.S. assets for the benefit of her U.S. beneficiaries. She names herself and her son (who is a Canadian resident) as co-trustees. In accordance with the rules described in IRC Sec. 7701, the trust is a foreign trust and the transfers by the trustor are subject to the reporting requirements described in IRC Sec. 6048. If the trustor's advisor fails to recognize that the trust is a foreign trust because he or she was not aware of the son's residency in Canada, the advisor will fail to inform the trustor of the significant foreign trust reporting responsibilities whose failure to meet could trigger several penalties. Additionally, a foreign trustee can trigger foreign income taxes (in this situation Canadian) that create an even larger tax liability for the foreign trust.

B. Statement of Domicile.

Determination of Domicile has significant impact on a decedent's estate:

a. Domicile is important for legal considerations such as the location for probate and formal requirements for a valid will. The laws applicable to such fundamental rights as the

spousal right of election against a deceased spouse's estate, principal and income rules that affect trust distributions, investment and income taxation, can vary considerably from state to state.

b. However, domicile has important consequences as well because domicile determines what local property law will be applied for federal tax purposes.

c. In addition, domicile is determinative of the state tax burden, which may be substantially different from the federal tax burden.

d. For tax purposes, an individual should only have one domicile. Uncertainty about the state of a person's domicile may cause multi-state taxation and other complications.

e. A foreign domicile can bring added complexity since different tax bases and exemptions apply and treaties may affect taxability.

f. Rev. Rul. 74-424 which modified Rul. Rul. 66-85 states that the time zone when a decedent is domiciled determines the date and time of death. Since the domicile of the decedent determines the place from which the estate tax return is to filed and liability for the Federal estate tax arises in the United States at the time of death prevailing at the same instant throughout the world, the time and date of death of the decedent is the time and date prevailing in the decedent's domicile in the United States at the instant of death.

C. Trust Situs.

a. Except in the case of a testamentary trust, the trust instrument may fix the law applicable to the trust. This flexibility may be beneficial in situations where the trustor owns substantially appreciated property in a community property state and anticipates moving to a separate property state.

b. Economic turmoil has resulted in many clients losing their jobs so the movement of trust beneficiaries has likely increased, perhaps impacting trust situs. Also, economic pressures have forced many states to step-up enforcement of tax audits and increase tax rates. Thus, even if a decision was made recently as to state situs, it may be worthwhile for practitioners to revisit the analysis.

D. Specific Bequests

a. Many clients like to keep everything equal among their children. It starts at Christmas and carries on throughout their lives. This includes gifts and bequests.

b. But what may be equal at one point in time, may not be equal at a later time because of changes in values.

c. A client may leave one specific asset to one child and another to a second child and the assets may be of equal value at the time the gift was contemplated and reflected in the Will or Trust. For example, a client could make gifts that may have been funded with specifically stated stocks or mutual fund shares (e.g. 100 shares of Citibank or GM stock). What was once an estate plan with equal gifts to children may now be lopsided because the value of the assets has changed.

d. Many changes may occur in the asset values between the time that the estate plan was created and when the grantor dies and the specific gift provisions actually takes effect.

e. Additionally, the FMV of the asset is not the only indicator of value. The gift could be a retirement plan that is chocked full of income tax consequences payable by the recipient. Or other taxes could diminish one asset over the other resulting in inequality (and probably not the grantor's intent).

f. A quick review of the plan could spot these types of gift issues and prompt the grantor to reconsider them.

> Example: Client Plan leaves the house (worth $1.0M) to Child A and life insurance proceeds of $1.0 M to Child B. But the house may have appreciated or depreciated. In larger estates, there could also be an unequal allocation of taxes based on the specific bequest. This would be easily discovered in a review of the plan and simple adjustments could be made.

E. Charitable Bequests

Some testators may have left generous gifts to non-profit organizations on the belief that their other assets would be sufficient to provide adequately for their families. Now, in light of declined asset values, families may no longer have the same financial security and testators may wish to modify their charitable bequests. Review charitable bequests to:

a. Make sure that the charitable bequest still fits the estate;

b. Determine whether the once reasonable bequest to charity, based on the value of the estate, has become disproportionate because of a decline in values;

c. Consider whether to make charitable bequests from retirement accounts where there will be both estate and income tax savings; and

d. Determine whether a simpler gifting strategy (maybe to a community foundation) is a better solution than a CRT or Family Foundation where significant administrative responsibilities are involved.

F. Review Section 529 College Savings Plans

With recent changes to the Kiddie Tax, 529 Plans provide a more viable option for many clients. If the economy has tanked the client's Sec. 529 Plan, a suggestion would be to sell the assets, take the loss, close out the plan and start over with a new 529 Plan.

G. Life Insurance

a. Life insurance is an important tool in estate planning as it provides liquidity to the insured's estate to pay estate taxes or other expenses.

b. It can also be used to supplement or even create an estate for the support of the family in the event of the insured's death.

c. In a situation involving a closely held business, it can provide the funds for the purchase of the decedent's interest under a buy-sell or other shareholder agreement.

d. The insurance can be purchased in a way that keeps the proceeds out of the insured's estate which is extremely important in larger estates with large policies.

e. If potential estate taxes are no longer a concern because of the increased applicable exemption or reduced value in assets, the issue of continued coverage should be explored.

f. Below is a list of items important to a client insurance analysis and worth spending a few minutes to review:

- (i) Make sure the insurance carrier is sound and well rated;
- (ii) Identify the beneficiaries of the policy and make sure these designations are still current;
- (iii) Determine whether the policy is sustaining itself by paying its own premiums or whether the premium payments are a burden to the client;

(iv) Consider an ILIT to manage the proceeds and to remove them from inclusion in the decedent's estate. Be mindful of the 3 year rule if the policy is presently owned in the individual's name;

(v) Consider the life settlement market. In the right circumstances, this could be a life saver to an insured older person who has fallen on hard times. It may simply prove an economically sound alternative to disposing of a policy which is no longer needed;

(vi) Bear in mind trustees of life insurance trusts have fiduciary responsibilities; and

(vii) Consider the relinquishment of incidents of ownership of policy. Brush upon what constitutes an "incident of ownership." "Incidents of ownership" includes not only the technical ownership of the policy but any rights to the economic benefits from the policy that includes:

- The power to change the beneficiaries;
- The power to change the time or manner of enjoyment of the policy or proceeds;
- The power to borrow against the policy;
- The power to surrender or cancel the policy;
- To assign or cancel the assignment of the policy; and/or
- The power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy;

An application unaccompanied by the premium payment does not create an incident of ownership since the application clearly states that the policy would not be issued until the premium was paid. If insurance is owned by an irrevocable trust or a custodianship, the insured should generally not serve as trustee or custodian to avoid retaining incidents of ownership in the transferred policy. IRC Sec. 2041.

Incidents of Ownership in a corporate policy –corporate owned policy of life insurance will be attributed to a controlling shareholder only to the extent of the amount of proceeds not paid to the corporation.

(viii) Is the client in communication with his or her agent and being well served by that agent?

H. Tax Apportionment.

Taxes may constitute a major obligation of an estate and can adversely affect the liquidity of an estate or trust. Taxes that may be paid out of an estate may include income, estate and GST taxes. How the tax liability on an estate is apportioned among the beneficiaries is very important as it directly impacts the net amount that will go to each beneficiary.

Equitable Proration

California law under Prob. C Sec. 20100 – 20125 provides for the payment of taxes and indicates that such taxes are allocable among the beneficiaries of taxable property in proportion to what each beneficiary receives. There are also federal apportionment provisions as well. These rules govern the proration of federal and California estate taxes, including interest and penalties on deficiencies [Prob. C Sec. 20100(a)]. Proration rules relating to GST taxes are set forth in Prob. C Sec. 20200 – 20225. These rules reflect the public policy position that in the absence of a specific contrary direction from the testator, the burden of transfer taxes should be allocated proportionately among the beneficiaries of the taxable estate. These statutory rules do not apply when federal law directs otherwise. For instance IRC Sec. 2207A(a) provides that the tax on qualified terminable interest property (QTIP) will be at the highest incremental bracket with the result that other property in the estate is taxed at lower brackets. In this situation the California proration rules must yield to the federal law and the higher tax attributable to the QTIP property must be recovered from that property. Also if property is valued under the special valuation rules of IRC Sec. 2032A, the reduction in taxes must be allocated entirely to the person who receives the specially valued property. If the use requirement is not met for at least ten years, any taxes recaptured must be imposed on that same person (Prob. C Sec. 20114).

The statutory equitable proration statutes also don't apply when there are more specific proration rules applicable to income interests in trusts, estates for years, estates for life, and other income interests, or to specially valued farm and business property. Also, in a trust situation where there are both income and remainder beneficiaries, the transfer tax on both the current and

remainder interest is charged against the corpus of the trust and not allocated between the current and future interests (Prob. C Sec. 20113).

Lastly, the decedent can override the state or federal rules by directing a different source of payment [Prob. C Sec. 20110(b)(1)]. Problems that arise in this area come from:

a. Inartfully drafted tax apportionment clauses;

b. Lack of coordination between different clauses in different instruments; and

c. Miscalculations by the client or the planner concerning the size of the source of payments.

A recurring problem, that would be easy to spot in a review, is the overuse of these specially drafted proration clauses that purport to charge all death taxes to the residue of an estate or living trust. These provisions override the equitable apportionment statutes and can wipe out the residue if the residue is smaller than expected or there are assets outside the residue that are sizeable and taxable. Drafting errors in tax apportionment clauses can result in the distribution of a client's wealth in a significantly different manner from that intended by the client.

Careful attention must be paid to a trust or will provision that directs taxes to be paid in a certain way or out of a particular fund if any portion of the decedent's estate is designed to qualify for the marital or charitable deduction. If a trust or will provision requires the residue to bear the full burden of paying the transfer taxes, will reduce either the marital or charitable deduction and this could create estate tax liability on the first death. (Totally going the wrong way!!)

Right of Reimbursement

The fiduciary has a duty to recover that portion of the taxes attributable to property that does not come into his or her possession from the persons chargeable with the payment of those taxes under the statutory rules of proration. If there is both an estate and revocable trust, if the executor cannot collect from any person, the amount not recoverable must be equitably prorated among the other persons interested in the estate that are subject to proration [Prob. C Sec. 20116(b)]. Any person who is required to pay more than the required amount of taxes because someone else has not paid his or her proportional share has a right of reimbursement against the

other person under Prob. C Sec. 20117(a). This right of reimbursement can be enforced directly against the person who owes taxes or it may be enforced indirectly through the personal representative. Either may bring a judicial proceeding to compel the reimbursement of these taxes.

Determine Client's Wishes

Sometimes clients want gifts to go to certain beneficiaries free of estate tax but it's important to make sure that this is the clear intent of the decedent and not because the tax allocation clause was drafted badly. For example, a client may want small specific gifts to pass to certain beneficiaries without the imposition of transfer taxes. Where the tax implications of this are minimal, it is reasonable. However, if the gifts are substantial and generate significant transfer taxes, this should be carefully considered with the client. This could easily be spotted in a review of the will or trust.

If specifically tailored tax clauses are used, the tax apportionment clause must normally appear in the document that disposes of the particular property that is to be used to pay the tax.

> Example: Both spouses have children from prior marriages. The decedent spouse dies with a taxable estate of $4.5 million. The estate plan directs that $3.5 million goes to his children and $1.0 million to the surviving spouse. The surviving spouse doesn't need the money and disclaims the $1.0M gift which then passes to her children. As a result of the disclaimer, there is now a taxable estate of $1.0M which generates $450,000 in estate taxes.

Under equitable proration, $350,000 of this tax is attributable to the decedent spouse's children and $100,000 to the children of the surviving spouse.

Such an inequitable result would not have occurred had there been specific language in the trust that would direct that the burden of the tax to those beneficiaries who benefited from the disclaimer.

Any increase in estate, generation-skipping or inheritance taxes, including interest and penalties, resulting from a qualified disclaimer shall be paid from the disclaimed property.

I. Review Retirement Plans.

a. Check on designated beneficiaries.

b. Review pension law changes.

c. Review required minimum distributions.

d. Analyze Non-spousal rollover rules.

e. Consider converting a traditional IRA to a Roth IRA .

J. State Tax Changes.

a. Make sure that clients have amended their wills and trusts to minimize state estate taxes. Caution needs to be exercised from two perspectives. State estate tax is assessed at much lower rates than federal tax so that the value of more costly estate tax minimization techniques that may have been warranted when both a federal and state estate tax applied, but may not be economically viable if only a state estate tax applies. That being said, practitioners should still protect themselves by offering planning opportunities and documenting when clients reject them.

b. The decoupling of federal and state estate tax systems and the increase in the federal exclusion also has surprising ramifications to post death determination of tax basis. When a federal estate tax is due, clients will file a federal return and the valuation data collected will confirm tax basis for future sales. However, if no federal return is filed, and perhaps not even a state return, what can be done to corroborate income tax basis step up on death?

c. It is important to remember that different states have different rules. Therefore, knowledge of state law is essential. As mentioned previously, California repealed its inheritance tax many years ago and cannot reinstate it without a constitutional amendment. Other states are actively collecting inheritance taxes.

K. Succession Planning.

Any transaction based on valuations should be revisited. If a business uses a stated value purchase price (the equity holders agree on a set price to govern any buyout) that price should be revisited and revised if appropriate. The value of the business may have declined substantially as a result of recent economic developments. If the certificate is not revised there could be an incentive for one partner to resign, or terminate, and exact an unreasonable buyout from the remaining partners. Any formula valuation clauses should be revisited. If the fundamental economics of the business have changed, the old formula may simply not be viable.

L. Alternate Valuation Date.

Instead of valuing assets as of the date of death for estate taxes, estates can opt to use an alternative valuation date which is generally 6 months after the date of death. In light of declining value for many assets, practitioners who are handling estates of decedents who died within the past 6 months or who die before there is a meaningful economic recovery, should obtain alternate values for assets to determine whether an alternate valuation election is appropriate.

M. Stale Trusts.

Stale trust administration refers to the situation where perhaps the decedent spouse died and the surviving spouse did nothing with regard to administering the marital living trust. When the surviving spouse eventually dies or seeks help, often a significant period of time has passed. It becomes increasingly difficult and expensive for the lawyer and accountant to sort out the details of a neglected and commingled estate plan. A significant delay in administering a trust after the death of the grantor or the first spouse can throw a well drafted estate plan into chaos. A "stale trust" can result as a consequence of:

a. A trust that the trustee has neglected or abandoned.

b. A trustee's disregard of the trustee's fiduciary duties during the term of the trust.

c. A trustee's failure to fund the Bypass Trust and the Marital Deduction Trust at the death of the first spouse.

d. A trustee's failure to properly administer the subtrusts.

There is not a great deal of information or guidance about how to handle a stale trust administration but the job of the advisor involved in this process is to do the best job possible under the circumstance to recreate the situation that should have occurred at the time original trust administration was triggered.

TRUE STORIES THAT ENDED BADLY.

This discussion today was partly motivated by horrors stories coming out of practitioners' estate planning practices where a bad ending could have been easily resolved if someone had reviewed the decedent's estate plan before death.

a. Herb & Edith

b. John & Alice

c. Other horror stories

ESTATE PLANNING ISSUES AND UPDATES

CHAPTER 2

Trust Administration

Trust Administration is the title given to an expansive fiduciary practice area that includes multiple disciplines and authorities. It includes law, tax and accounting as well as other investment and economic decisions that directly impact the assets contained in a trust or estate. Trust administration requires that those persons responsible for the competent administration of a decedent's estate make reasonable and thoughtful decisions as they can have long-term financial and tax consequences to the respective beneficiaries. Accounting and taxation rules must be understood and carried out. This is a challenging area of practice for both the fiduciary and those who advise the fiduciary as a great deal of postmortem planning is possible during this window of time. This conference presentation focuses on some of the issues that occur and the unique issues that arise with spousal estate planning clients. They do not discuss domestic partners or same sex couples who as of this date do not benefit from the IRC Sec. 2056 unlimited marital deduction.

When a person dies, there ensues a difficult period of time for family members and friends. In the midst of this emotionally charged environment, many administrative tasks must be performed. Often several different professional advisors are involved in this process. There are various tax reporting responsibilities that involve transfer and income tax issues and the choice of particular elections and tax options can have a significant impact on the amount of taxes incurred and paid. The more sophisticated the estate plan, the more complicated the administrative issues.

Also when a death occurs, additional taxpayers come into being in the form of the estate or administrative trust, and decisions must be made regarding where to take certain deductions on the various tax returns. Additionally, new entities are formed or the current entities changed. It is important that the advisors assist the fiduciary and the family to gain control of the situation. Sometimes this involves educating inexperienced members of the estate planning team. Different heirs may have very different interests and this may prove to be very challenging to the impartial fiduciary. Some beneficiaries may be impatient with the administrative process and

want their inheritance before proper steps have been taken. The different dynamics make it all the more important to have someone or a team carefully guiding the process.

Administrative Issues Determined in the Estate Plan

Many people think that the death of the single grantor or the death of the first spouse begins trust administration but the reality is that trust administrative issues arise long before that. Trust administration has several phases and spans the period from the inception of the estate plan through its termination.

At the time that a client executes his, her or their estate plan, important decisions are made and are drafted into the plan that have long term consequences. Remember that the estate planning documents provide the "roadmap" for fiduciary administration and often will be used even if the provisions are outdated or don't reflect the grantor's actual intent at the time of death. This is the reason that clients must be encouraged to have their plan reviewed periodically in light of changes in the law or changes in their lives or their objectives.

Additionally, the fiduciary is bound by many of the decisions that are reflected in the provisions of the instrument. However, when a client dies with a fully funded revocable living trust, active trust administration begins.

a. This once docile revocable living trust (RLT) that was ignored for income tax purposes now comes to life and requires attention.
b. The directives stated in the governing document for this trust administration are often created much earlier.
c. The estate planning documents dictate important guidelines that are activated at death such as:
    - provisions for the successor trustee;
    - funding formulae;
    - directives to the fiduciary
    - distribution provisions: and
    - beneficiary designations.
d. Trust administration is just as rigorous as probate administration but without the court's supervision.

Trust litigation is on the rise.

With the increased use of trusts comes increased litigation regarding trust administration. Traditionally probate litigation mainly centered on disgruntled heirs fighting over assets – that will probably never change. But in the past few years we have seen increased litigation in the fiduciary area with beneficiaries suing trustees and their advisors over administrative issues involving:

a. The competent and accurate accounting for trusts and estates;
b. The prudent investment of fiduciary assets;
c. Proper funding decisions where multiple trusts are created; and
d. Allegations against the fiduciary of lack of impartiality among beneficiaries and favoritism.

Therefore, it is important that fiduciaries and those that advise trustees and personal representative fully understand the guidelines, standards and safe harbors that are available in this area.

Organization & Coordination

Because there are many different tasks involved in the post mortem period, it is important that the administration be well coordinated so that important dates and elections are not missed. Communication among advisors and between the advisors and the fiduciary is essential and the use of a checklist system is helpful to coordinate this effort. In more complicated estate planning structures where there are multiple entities, it is very important that the advisors understand the plan so that important deadlines are not missed. The primary advisors are usually the attorney, the accountant and often a trust officer if the entity is professionally managed. Additionally there may be investment advisors, insurance agents and appraisers.

The Importance of an Approach in All Trust Administration

A team approach is often necessary because of the interplay among and between disciplines. They include:

a. Legal analysis regarding construction and interpretation of the governing documents;
b. Accounting Issues;

c. Taxation of the Entities;
d. Investment Decisions; and
e. Fiduciary management.

Each one of these areas often requires computation and calculation based on independent authority.

a. The gross estate uses FMV (for purposes of the Form 706);
b. Formula clauses are imbedded in the governing document;
c. Fiduciary accounting is based on state statutory accounting rules or provisions in the trust;
d. Gross income for taxation follows the rules for individuals; and
e. The allocation of tax between the entity and the beneficiary follows Subchapter J of the IRC; and
f. Investment decisions must follow the Prudent Investor Act unless overridden in the trust document.

There is much to do in trust administration and all of the responsibility for competent administration ultimately rests with the fiduciary.

Areas of Discussion:

I. Introduction to Trust Administration
II. Trust Administration with Married Clients
III. Common Estate Plans with Married Clients
IV. Funding Formula Clauses and the Death of First Spouse
V. Economic Consequences of Formula Clauses
VI. Special Issues with Formula Clauses

I. TRUST ADMINISTRATION WITH MARRIED CLIENTS

Estate planning for spouses has special characteristics. Because the assets owned by married couple are considered a community of assets, there are favorable tax laws and special preferences that must be considered when dealing with families and married couples. This section analyzes the aspects of trust administration particular to spouses.

Many married clients erroneously believe that once they complete the drafting stage of the estate plan and transfer the assets into their living trusts, nothing else needs to be done until the second spouse dies. This myth is fueled by the fact that generally no estate taxes are due on the first death and a fully funded living trust avoids the necessity of a formal probate administration. So it comes as a big surprise, often a shock, when the first spouse dies, and the family discovers that a significant number of legal and accounting issues must be addressed and resolved. It's an even greater shock how much this additional work costs in terms of professional advisor fees. While it's true that a funded living trust often avoids the formal probate administration, there are still important administrative duties that must be performed and decisions to be made outside the supervision of the probate court. If a trust is not properly administered, there can be severe legal, economic and tax problems further down the road.

At each phase of trust administration, there must be coordination and consistency with the grantors' estate planning documents and a keen eye focused on the type of assets that comprise the estate. To begin trust administration planning at the death of the first spouse, when the family trust breaks into the subtrusts described in the estate plan, is often too late. Because the rules and formulae used to fund the subtrusts have significant and different income and estate tax consequences, it is important to make sound, informed decisions regarding investment, accounting and administration of the subtrusts early in the estate planning process. Improper funding can result in a myriad of problems that include:

a. Acceleration of income tax or gain on funding an IRD asset improperly;
b. Taxation of part or all of the bypass trust on the second death under the provisions of IRC Sec. 2036(a);
c. Loss of the use of the marital deduction resulting in estate taxes;
d. Loss of the S election on stock not meeting the requirements under Sec. 1361;

e. Recognition of capital gains on funding a pecuniary formula trust;
f. Loss of preferential tax treatment under Sec. 121 on the sale of the personal residence if the residence is funded into the wrong trust.
g. Failure to take discounts on the first death or loss of the ability on the second death;
h. Potential unintentional carrying out of DNI on funding pecuniary share;
i. Loss of all or part of the GST exemption;
j. Loss of step up in basis on second death for assets funded into bypass trust
k. Unhappy and dissatisfied beneficiaries when they learn of lost opportunities and problem funding situations.

Estate Documents for Spouses and State Law

In estate plans for married clients, the state in which they reside is very important in determining the character of the assets and how they are held. State law traditionally has been divided into separate and community property states with a majority of the states following a separate property regime. Therefore, the first inquiry made in trust administration on the death of the first spouse is what state law governs the estate plan.

Trust provisions are usually inconsistent with the survivorship rights of a joint tenant and so making a joint tenancy asset subject to a revocable trust should sever the joint tenancy. It is always helpful to include an express provision declaring this. Severance of a joint tenancy asset creates the presumption that the property is now owned as equal shares of separate property.

Assumptions Used During Trust Administration

Certain assumptions must be made during the term of trust administrative that allows the process to move forward. They include:

- Utilizing Immediate Creation versus Administrative Trust
- Internal Allocation versus Formal Transfer of Assets

Immediate Creation or Pass-Through Approach

The revocable trust technically ceases to exist for the decedent taxpayer at the date of death and should therefore be ignored for income tax purposes. Under the immediate creation

theory, the assumption is made that all gifts and transfers are made as of the date of death regardless of when the revocable trust is physically divided. Therefore, all trust income is taxed to the subtrusts or other beneficiaries, respectively, commencing with the date of death. This alternative works in the following situations:

1. Where the trust assets are not complicated and can be easily identified and valued.
2. Where allocations can be made a short time after death.

In the spousal situation where subtrusts trusts are created at the first death, the surviving spouse's separate property and share of joint property are treated as an "owned portion" of a trust that is taxed to the surviving spouse rather than to the trust under the grantor trust rules because of the spouse's continued power of revocation as to that portion. The result of the immediate creation approach is that trust income will be reported directly by the subtrusts and fiduciary income tax returns are filed for each irrevocable subtrust.

When the subtrusts include a bypass trust or a marital deduction, the "immediate creation" approach compels rapid decision making about asset allocation. The immediate creation theory is simpler to administer because it does not require the creation of a separate, interim entity. If enough time remains in the calendar year to distribute the assets to the subtrusts, and the decedent's assets are fungible or easily valued, the use of the immediate creation approach by the trustee should be seriously considered.

Reasons for Delay in Funding the Subtrusts

1. Difficulty in identifying assets.
2. Difficulty in determining what is joint and what is separate property.
3. Problems in valuing assets.

The Administrative Trust

If funding the subtrusts is not possible, there must be some receptacle to hold the assets that were in the revocable trust. These assets must continue in an administrative trust until distributions to the subtrusts are made. The term of the continuing trust or "administrative trust"

commences on the date of death and ends on the date of the final funding of the subtrusts. Therefore, an administrative trust should be used in nearly every administration in which assets cannot be distributed to the subtrusts in the year of death.

In the law of trusts, a trust cannot exist without a "res" or property. This is codified often in state law that requires that a trust is created only if there is trust property. Therefore, until the various subtrusts are funded with at least some assets, one can argue that there are no such subtrusts in existence for which to file fiduciary returns and that an administrative trust is required. Other tax professionals make the argument that a revocable trust functions like a probate estate and that the revocable trust (the administrative trust) should be treated as a separate taxpayer during the period between the date of death and the date the separate trusts are funded. If one can expect to administer a decedent's trust for more than 12 months or over the course of more than one tax reporting year, an administrative trust will be necessary.

Most instruments provide no express authority for the creation of the administrative trust. It should be pointed out that the administrative trust is an income tax device only (See PLRs 9645006 & 9644001). It is helpful to compare the administrative trust to the probate estate as an interim step between the revocable trust and the division of that trust into the decedent's subtrusts. A persuasive factor encouraging use of an administrative trust is the litany of responsibilities imposed on the fiduciary by the IRC and the language in the Regulations can be construed to require the use of an administrative trust [Treas. Reg. Sec. 20.2053-8(a)(2)].

Additionally, there are Regulations related to the termination of a trust and its winding up period [Reg. 1.641(b)-3(b)] that lend credence to a recognition of the administrative trust; i.e. that it exists during the "winding up" period between the deceased spouse's date of death and its division into separate survivor's, bypass, and marital trusts.

The Advantages of an Administrative Trust

1. Provides a vehicle by which the fiduciary can satisfy the various responsibilities associated with distributing the decedent's assets.
2. Gives the trustee time to do income and estate planning, creditor protection planning, disclaimer planning and other nontax planning.

3. Helps the trustee in making deliberate and sound valuation decisions for tax and distribution planning.
4. Under this approach, the trustee treats the subtrusts as having been created when the assets are actually distributed to them.
5. It provides the ability of the trustee to make a Sec. 645 election and treat the administrative trust as an estate for income tax purposes.

Practical Considerations

Some estate plans are drafted in a manner that effectively compels the use of an administrative trust. The most obvious example involves a plan providing for a pecuniary marital deduction trust and using the proper delay in actual funding to permit the bypass trust to benefit from the asset appreciation and income of the entire trust.

1. The administrative trust will continue during the period reasonably required to complete administration and distribution of the trust assets to the successor beneficiaries.
2. The administrative trust can serve as a buffer between the decedent and the beneficiaries, similar in function to a probate estate. For that reason, the beneficiaries can argue that they have not accepted the benefits of the property prior to the funding of the subtrusts.

Mechanics for Establishing the Administrative Trust

1. Obtain employer ID number from IRS.
2. Affidavit of Successor Trustee should be completed.
3. When appropriate, the Affidavit may be recorded.
4. A Certification of Creation of Administrative Trust may also be prepared.
5. Fiduciary should file Form 56 with IRS and FTB. (Attach copy of trust instrument).
6. Filing Form 56 is not necessary if the first trust income tax return is due within a short time after death. In that case, the fiduciary income tax return serves as notice in lieu of the Form 56.

7. At the termination of the administrative trust, another Form 56 should be filed indicating that the trust has terminated.

Entitlement to Income During Term of Administrative Trust

Income earned during administration is allocated to the residue except for net income earned from property specifically devised and interest due on delayed distributions of pecuniary gifts. CA Prob. C Secs. 16340 and 16341 of the '97 *Uniform Principal and Income Act,* dedicate separate provisions to the accounting for assets during the administration of the decedent's estate.

The Trustee of the Administrative Trust

Many important decisions are made during the pre-funding period and the trustee of the administrative Trust makes many of these decisions. The administrative trust is often the holding vessel for the Bypass Trust and the QTIP trusts until the assets are valued and the subtrusts funded. The provisions of the governing instrument generally indicate the party or parties that are appointed as the trustees of both the Bypass the QTIP trusts. The document should be reviewed to determine whether a provision addressing this issue is included in the instrument. If the instrument is silent, the named trustee of the subtrusts should act as trustee of the administrative trust during this pre-funding period. If there are different trustees named to different trusts, they will act as co-trustees of the administrative trust unless there is a contrary provision in the governing instrument. The new regulations under IRC Sec. 663 indicate that separate share treatment should be accorded the administrative trust.

Creative Uses of the Administrative Trust

Because of the manner in which the administrative trust is taxed and the few restrictions placed on administrative trusts, these trusts present an opportunity in administrative planning when a surviving spouse dies and multiple irrevocable subtrusts are in place and programmed to terminate. If there is expected a lengthy administrative period and one irrevocable trust is producing taxable income while another is generating losses, the combination of these trusts into an administrative trust could allow the mechanism to offset the income with the losses. Because

of the way separate shares are taxed under IRC Sec. 663, there exists very viable planning opportunities in the right set of circumstances.

Important Tax Tools of Spousal Estate Planning

The two important tools of trust administration with spousal clients are the lifetime exclusion and the unlimited marital deduction. A well conceived and well drafted estate plan will achieve the optimal benefits from utilizing these tools.

The Lifetime Exclusion

Over the years, the tax law has allowed all individuals to pass a certain amount by gift during life or at death without the imposition of gift or estate taxes. This amount has varied over the years and the testamentary exclusion increased significantly during 2000 – 2012 to the current amount of $5,120,000 which applies to both inter vivos or testamentary gifts. Because of uncertainty in the estate tax law, however, the exclusion is set to return to its 2001 amount of $1,000,000 on January 1, 2013 unless legislation is enacted.

The Unlimited Marital Deduction

An unlimited marital deduction is available for gift transfers of property between spouses who are U.S. citizens under IRC Sec. 2523(a). The deduction does not apply to a noncitizen donee spouse, but the annual exclusion for gifts under IRC Sec. 2503(b) has increased to $139,000 (2012), plus cost-of-living adjustments.

The Marital Deduction

There is a public policy interest in preserving the marital financial community even if one of the spouses dies. This is the reason that the marital deduction was created. It is now unlimited which means that gifts or transfers between spouses are not subject to gift or estate tax. This is a very powerful tool in estate planning and the marital deduction is one of the largest deductions available at the death of the first spouse.

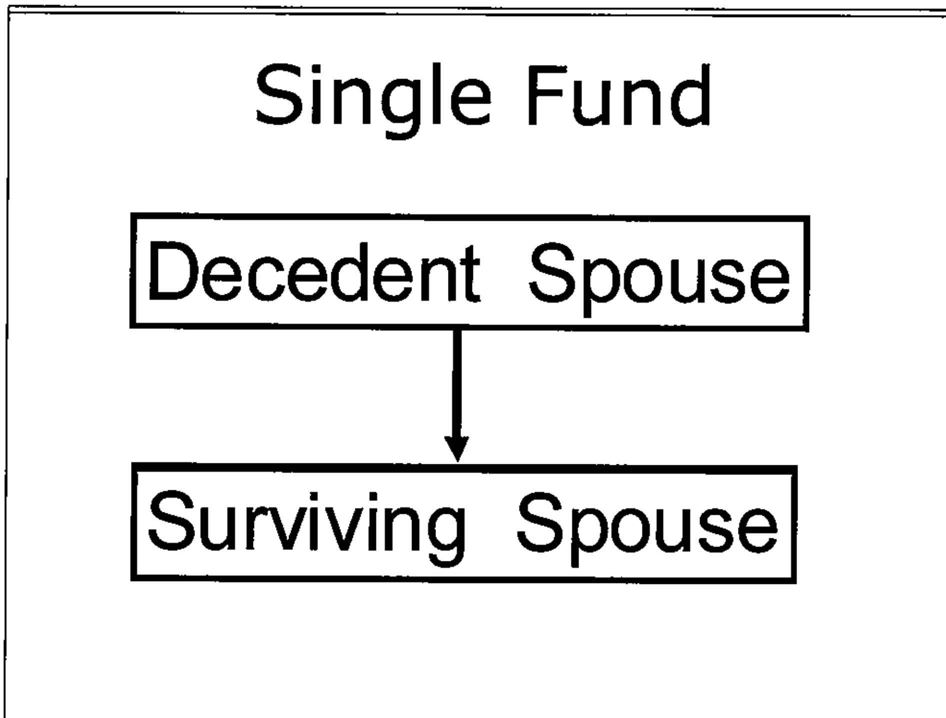
Requirements for All Marital Deduction Gifts

In order to qualify for the marital deduction under IRC Sec. 2056(a), four requirements must be met. They are:

a. The decedent must be survived by a spouse who is a citizen of the United States;
b. The interest must *pass* to the surviving spouse;
c. The interest must be includable in the decedent's gross estate; and
d. The interest must not constitute a nondeductible terminable interest.

II. COMMON ESTATE PLANS INVOLVING SPOUSES

The Single Fund Revocable Living Trust



In the single fund estate plan, if one spouse were to die (decedent spouse), that spouse's share of the assets would be gifted to the other spouse (surviving spouse). The surviving spouse would be entitled to the income earned from the assets and have complete autonomy to decide how the assets would be distributed upon the surviving spouse's death. Therefore, it is possible to completely defer estate taxes on the first death by having the decedent spouse leave all his or

her assets to the surviving spouse. The only problem with this strategy is that it only defers the estate tax and it often doubles the size of the estate of the surviving spouse. In the blended family situation, the decedent spouse may want to provide for the surviving spouse but ultimately have control over the final disposition of the assets, perhaps to children from a prior marriage.

It is important to note that in the single fund plan, because the surviving spouse controls the assets, the decedent spouse has no guarantees that the surviving spouse will actually make any promised bequests to the intended beneficiaries. Therefore trust and confidence between the spouses is very important in this type of plan and spouses with long term marriages are the best candidates.

The Concept of Portability and the Relief Provided by Portability

The 2010 Tax Relief Act [IRC Sec. 2010(c)] enacted "portability" between spouses of the estate and gift tax exclusions for deaths occurring in 2011 and 2012. Depending on legislation that occurs before 2013, it may continue into future years. It is a good concept in certain situations as it remedies the loss of the exclusion on the first death under the "use it or lose it" regime of prior law. Prior to the 2010 law, if no estate planning is done or all the assets of the first spouse to die passed to the surviving spouse under the unlimited marital deduction, this favorable tool was unused and wasted. Under the new law, a post mortem election made on the decedent spouse's estate tax return can now preserve all or a part of the decedent spouse's applicable exclusion amount and combine it with the applicable exclusion amount of the surviving spouse. The deceased spouse's unused exclusion amount has been termed "DSUEA". It may be used by the surviving spouse for lifetime gifts or at death. One of its greatest limitations, however, is that it is not available for GST transfers. IRC Sec. 2010(c)(2) changes the definitions previously used. The "applicable exclusion amount" is now the sum of the "basic exclusion amount" and the first spouse's unused exclusion amount. This is termed the "deceased spouse's unused exclusion amount or DSUEA."

Additionally, the definition of DSUEA is very important. DSUEA is the lesser of the basic exclusion amount (currently $5,120,000 million in 2012) or the excess of the last deceased spouse's basic exclusion amount over the deceased spouse's taxable estate under IRC Sec.

2011(b)(1). Because of this language, there are certain risks that involve the future of the transfer tax law.

It should be noted that the first spouse does not have to own assets equal to the exclusion amount (currently $5 million) to transfer that amount to the surviving spouse.

While the current basic exclusion of $5 million is adjusted for inflation in multiples of $10,000 starting in 2010, the DSUEA is not adjusted and this could result in an amount considerable less than the surviving spouse's exemption.

Required Portablility Election on Estate Tax Return

Per IRC Sec. 2010(c)(5), in order for the surviving spouse to utilize the portability election, an election must be made on the deceased spouse's timely filed estate tax return. Once made, this election is irrevocable. In smaller estates, this will result in situations where an estate tax return will only be required to make the election. Also clients must be proactive as IRC Sec. 2010(c)(5)(B) does not allow the election if the estate tax return is filed after the extended due date. Perhaps future regulations will lesson the hardship this rule presents. Also, the time for auditing the estate tax return that contains the election is extended as to this issue indefinitely.

Conforming Amendments

An amendment to IRC Sec. 2505(a)(1) now includes portability for gift taxes. Thus, the surviving spouse may use the DSUEA on lifetime gifts. Also IRC Sec. 6018(a)(1) which sets the gross estate threshold for when an estate tax return must be filed, was amended to replace the "applicable exclusion amount" with the "basic exclusion amount." The result is that the filing requirement threshold for the surviving spouse remains the same and is only tied to the decedent's exclusion amount without regard to any DSUEA.

Lifetime Gifting Options Under Portability

If the spouses rely on portability in their estate plans, the surviving spouse can make larger gifts after the death of the first spouse. If one spouse dies during 2012 without making any lifetime gifts and an estate tax return is filed, the surviving spouse will have an applicable exclusion amount of $10,120,000 (DS's $5,000,000 DSUEA and SS's Basic Exclusion of $5,120,000). The surviving spouse can make lifetime gifts of $10,120,000 without the imposition

of gift tax. However, the GST exclusion amount is not available on the DSUEA amount and therefore dynasty trust planning is only available on the surviving spouse's basic exclusion amount.

Income Tax Advantages with Portability

If assets are transferred directly to the surviving spouse under portability and not into a bypass trust, the assets at the surviving spouse's death are available for a basis adjustment under IRC Sec. 1014. If the assets appreciate in value, this appreciation will be reflected in the basis of the assets and any subsequent disposition will result in no income tax gain to the estate or beneficiaries. The adjusted bases of assets that are transferred into a Bypass Trust are frozen at the time of transfer and any subsequent appreciation will result in gain.

Disadvantages of Portability

There is no doubt that portability serves a positive place in estate planning especially in smaller estate or specific asset situations. This is true especially in the situation where the assets appreciate and are adjusted to FMV on the death of the surviving spouse. However, there are disadvantages and they include:

a. The decease spouse's unused exclusion amount is not indexed and could decline in value;
b. The unused exclusion will be lost if the surviving spouse remarries, dies and survives his or her subsequent spouse;
c. The unused exclusion is a set amount and does not reflect growth in the assets between the two deaths;
d. Portability may terminate on Dec. 31, 2012;
e. Asset transfers to children from prior marriages cannot be protected in the same manner as they can with subtrusts;
f. The GST exclusion cannot be transferred under the portability provisions; and
g. Irrevocable trusts have asset protection features that would be lost under the election for portability.

Drafting Documents to Incorporate Portability

This deceptively simple concept of portability is complicated both in the planning and administrative stages. Clients must be consulted to determine their comfort level with the different aspects of portability and whether they want it as part of their estate plans.

The Creation of Subtrusts

The creation of subtrusts at the death of the first spouse has a long history of use and effectiveness that continue and should be explained to clients. There are many compelling reasons for continuing to use subtrusts on the death of the first spouse and these reasons should be explored with the spousal clients when their estate plans are executed.

In order to maximize the use of the marital deduction and the applicable exemption amount to their full capacities, a sub-trust scheme is often used that comes into effect at the death of the first spouse. At the death of the first spouse, the spouse's estates breaks into a variety of sub-entities that are described in the provisions of the governing instrument. Because the trust document becomes the roadmap, it is important that these provisions remain current and clearly reflect the settlors' estate planning goals.

The Survivor's Share

The surviving spouse's separate property and share of the joint property continued to be owned outright or in a revocable living trust is referred to as the survivor's share. If a trust is utilized, this trust continues for the surviving spouse's interest only. The trust continues to be revocable and the surviving spouse has the power to amend or revoke the trust in any manner. It also continues to be a grantor trust for income tax purposes.

Upon the surviving spouse's death, the assets will flow according to the provisions in the surviving spouse's will or living trust and this depends on the specific family situation. These provisions are drafted carefully to take into account the particular family structure and dynamics. It is not uncommon that the survivor's trust contains a general power of appointment making it possible for the surviving spouse to unilaterally decide how the assets will pass on the surviving spouse's death. If the power of appointment is not exercised, often the assets flow into the trusts created on the first death. This eliminates the necessity of separate sets of dispositive provisions for the different subtrusts.

The Bypass (Exemption/Credit Shelter) Trust

If all the assets are gifted to the surviving spouse and qualify for the unlimited marital deduction, there is no estate tax due on the death of the first spouse. But this technique is often shortsighted because if fails to utilize the decedent's spouse's applicable exemption amount which is currently $5,120,000 and translates to a significant estate tax savings. Additionally, any assets gifted to the surviving spouse will increase the estate.

Therefore, in order to utilize the decedent spouse's applicable exemption amount, while still providing for the surviving spouse, an irrevocable trust is often created at the death of the first spouse. It is called the "bypass trust," the "credit-shelter trust," the "exemption trust," or the "family trust." Sometimes it is assigned a letter such as the "A" or "B" trust and referred to as such in the governing documents. The purpose of this trust is the segregation of assets in an irrevocable trust that will absorb the applicable exemption amount on the first spouse's death. This trust is taxable at the first death but the tax is absorbed by the credit exemption. The bypass trust provisions often distribute the income to the surviving spouse and even principal under an ascertainable standard. At the surviving spouse's death, the assets will not be included in his or her estate as the trust was taxed at the first death, but rather will be distributed to named beneficiaries under the direction of the estate plan and "bypass" estate taxes.

Trustee of the Bypass Trust

The trustee of the Bypass Trust is named in the provisions of the decedent's spouse's estate plan. Often the surviving spouse is named as the trustee alone or in combination with another family member or a professional fiduciary. If the surviving spouse is also named as the sole beneficiary, care must be taken that principal may only be distributed to the surviving spouse under an ascertainable standard. This standard is often called HEMS which stands for distributions for "health, education, maintenance and support." Using this standard, the surviving spouse acting as trustee of the bypass trust may make distributions to himself or herself of principal without the assets being included in his or her estate at death. If an independent trustee is named, this standard is not necessary.

Beneficiaries of the Bypass Trust

The beneficiaries of the bypass trust are named in the estate planning documents. Often

the surviving spouse is named as the sole income beneficiary with children named as remainder beneficiaries. Or the surviving spouse and the children are named as both income and remainder beneficiaries.

Often in "blended family" situations, the children from prior marriages are named as beneficiaries of the bypass trust as a method of bailing out these beneficiaries prior to the death of the surviving spouse. This is especially helpful where the surviving spouse is much younger than the decedent spouse and closer in age to the children. In this way, the children do not have to wait for their inheritance until the death of the surviving spouse.

Distributions from the Bypass Trust

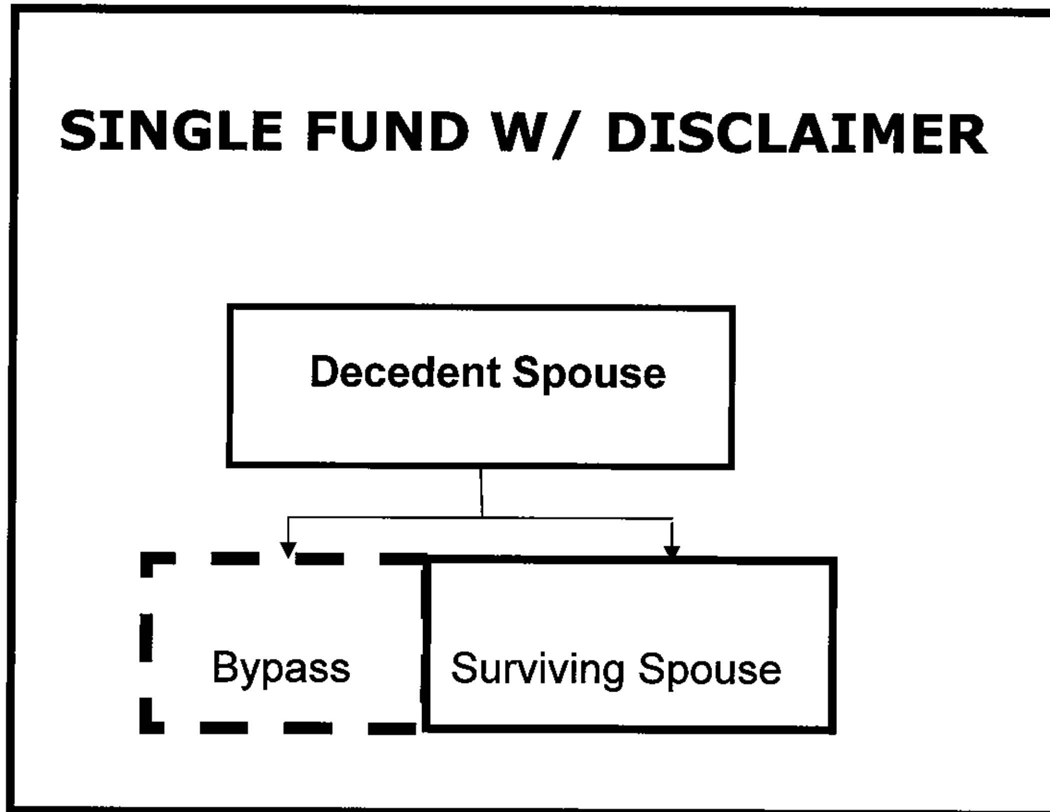
The distribution provisions for the Bypass Trust are found in the underlying estate planning document. The income is distributed to the income beneficiary of the bypass trust under a mandatory or discretionary directive. If there is a mandatory directive to distribute income to the current beneficiary, once the fiduciary accounting income of the trust is determined, it is distributed out to the income beneficiary. While a mandatory directive to distribute income to a surviving spouse as income beneficiary provides the most financial security for the surviving spouse, it is problematic as it automatically increases the estate of the surviving spouse by the amount of the distributions.

If there is a discretionary directive to distribute income or principal, the trustee has discretionary authority to decide whether to make distributions of income or principal. While providing less financial security to the income beneficiaries, it provides more flexibility.

On the Death of the Surviving Spouse

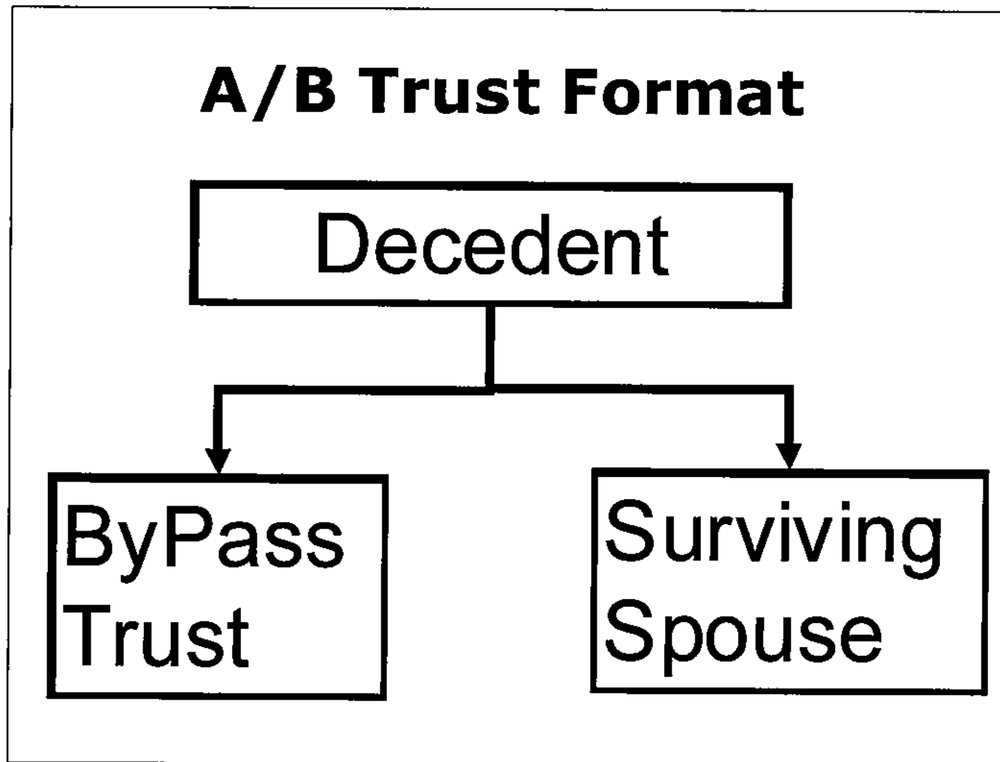
Where the surviving spouse is the income beneficiary of the bypass trust, this trust terminates on his or her death and passes, free of estate taxes, to the remainder beneficiaries who are often the children. Any appreciation in the assets that takes place between the deaths of the first and second spouse also passes free of estate taxes. Therefore, the choice of assets that fund this trust is very important.

Single Fund Trust with Disclaimer Provision



To create flexibility and accommodate the changes that often occur between the time the estate plan is created and when the first spouse dies, a single fund trust with a disclaimer provision is sometimes used. This type of estate plan leaves all the assets to the surviving spouse on the first spouse's death and allows the surviving spouse to disclaim at that time a portion often into a Bypass Trust or Share. This is a useful strategy where the marriage is long term, there are no blended family issues and trust between the spouses is not a problem.

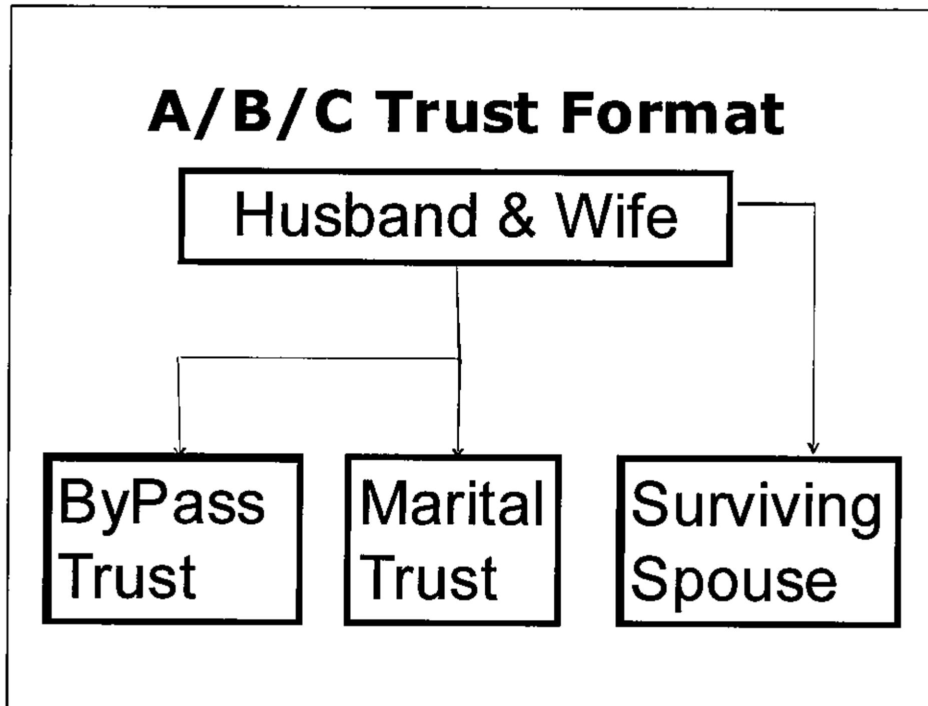
The Two-Subtrust (A/B Trusts)



This is a common model used for married couples where the spousal estate plan breaks into two shares at the first death; the bypass trust and the surviving spouse's ongoing estate or revocable trust. Any separate or joint property of the decedent spouse that is gifted to the surviving spouse, outright or in trust, qualifies for the unlimited marital deduction.

In this trust arrangement, the decedent spouse has control over the final disposition of the assets in the bypass trust and the assets are not included in the surviving spouse's gross estate at death. However, the surviving spouse has complete control over the assets in the surviving spouse's share and is free to gift the assets in any manner he or she wishes.

The Three (or more) Subtrust Format (A/B/C Trusts)



This model was created for estates in excess of the decedent spouse's applicable exclusion amount where ultimate control over the deceased spouse's assets is desired. The estate breaks into three subtrusts: the bypass trust, the marital trust (QTIP) and the surviving spouse's trust. Both the bypass and the marital trusts are irrevocable and the surviving spouse's trust continues to be revocable.

Trusts that Qualify for the Marital Deduction - The Marital Deduction Trust

A marital deduction trust allows the assets to pass from the decedent spouse to the surviving spouse and remain in trust while still qualifying for the unlimited marital deduction. At the surviving spouse's death, the assets pass to designated beneficiaries as described in the estate plan or through a power of appointed granted to the surviving spouse.

The QTIP Trust

A QTIP trust is widely used in estate planning because it is the only form of marital transfer that allows the decedent spouse to retain control over the eventual disposition of the

assets. This is a very powerful tool in blended family situations where there are children from previous marriages who may or may not get along with the surviving spouse. In addition, the assets in the QTIP trust are not subject to probate administration or the claims of the surviving spouse's creditors.

As discussed above, a nonqualifying terminable interest will not qualify for the marital deduction under IRC Sec. 2056(a). Examples of such interests are life estates, terms of years, annuities, patents, copyrights, and all interests that may terminate if a contingency occurs [Reg. 20.2056(b)-1(b)]. IRC Sec. 2056(b)(7) provides a statutory exception to the terminal interest rule for QTIP trusts. This irrevocable trust must provide for a life income interest to the surviving spouse and the deceased spouse's executor or trustee must make an election under IRC Sec. 2056(b)(7)(B)(i)(III) causing inclusion of the trust corpus in the survivor's estate under IRC Sec. 2044. During the surviving spouse's life- time, no distributions may be made to anyone else.

While the assets remain in the irrevocable QTIP trust, they will be treated as belonging to the surviving spouse for estate and gift purposes and, unless gifted inter vivosly, and will be included in the surviving spouse's estate upon death. The property will not, however, be aggregated with other property owned by the surviving spouse at death unless there is a general power of appointment. This is important in light of fractional share or minority discounts.

Spouse's Qualifying Income Interest in the QTIP

What exactly constitutes the required income interest to the surviving spouse is addressed in Reg. Sec. 20.2056(b)-5(f). The required income interest in a QTIP trust is present if the trust document as a whole gives the surviving spouse "substantially that degree of beneficial enjoyment of the trust property during his or her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust." [Reg. Sec. 20.2056(b)-5(f)(1). This standard will not be met if the primary purpose of the trust is safeguarding the assets without providing the surviving spouse with the requisite level of beneficial enjoyment.

The term "income" means fiduciary accounting income that is determined under traditional methods of fiduciary accounting or under the provisions of state law and may include a unitrust concept or the equitable adjustment method. The trustee's power to retain

unproductive property will not disqualify the trust if the surviving spouse is permitted to require that the trustee make the property productive or convert it within a reasonable time. Therefore the governing document should always contain such a provision.

Distributions of Principal to the Surviving Spouse from the QTIP

A QTIP may contain a provision that allows distributions of corpus to the surviving spouse but no one else. These discretionary distribution provisions must be used cautiously and only for those amounts needed by the surviving spouse. It must be remembered that the remaindermen of the QTIP have been chosen by the decedent spouse and this wish must be carried out by a conscientious fiduciary. If the surviving spouse is also the trustee, an ascertainable standard should be used to avoid giving the surviving spouse an inadvertent power of appointment.

Termination of Marital Trust at Death of Surviving Spouse

At the death of the surviving spouse, the marital trust will terminate and the assets will either flow to the remainder beneficiaries named by the first spouse to die or pass under a power of appointment. A limited power of appointment exercisable by the surviving spouse would exclude the surviving spouse, or the estate or creditors of the surviving spouse.

Pourover of Subtrusts into Bypass Trust

Under any number of provisions, the survivor's trust or marital trust may pour over into the bypass trust. The goal is to divide the marital estate equally between the two family groups upon the surviving spouse's death. Even if the bypass trust terminates on the death of the surviving spouse and the assets are distributed out, this structure will consolidate the estate plan and avoid unnecessary transfers of property. Again this treatment is dependent on the family situation and the estate planning goals of the parties. Problems can arise if the surviving spouse later amends the survivor's trust to leave all assets of that trust to his or her descendants. This could result in 75% of the assets going to the surviving spouse's family and 25% to the decedent spouse's family. Additional issues could arise when there is wealth or age disparity between the spouses.

The QTIPable Bypass Trust (Clayton Trusts)

Another method to build flexibility into the documents is through the use of the contingent QTIP. QTIP trusts are superior to other forms of marital deduction shares because they promote valuation discounts [(*Mellinger v. Comr*., 12 T.C. 26 (1999)] and enables a reverse QTIP election to be made for GST purposes. Also, the estate has up to fifteen months from death to modify a prior QTIP election (or non-election) provided that an extension of time to file the estate tax return was filed. The DSUEA can be applied to a QTIP trust creating very beneficial results in certain estate plans. The decedent's estate tax exemption is both used and frozen at the first death, the assets are protected for the remainder beneficiaries chosen by the decedent spouse and a basis adjustment is available when the surviving spouse dies. If flexibility for the surviving spouse is desired, a limited power of appointment can be granted to the surviving spouse.

There was a prior regulation that stated that if an income interest or life estate was contingent upon the executor's electing that treatment, the interest would not qualify for the marital deduction, regardless of whether the election was actually made. Three Tax Court cases supported this regulation and all three were reversed on appeal. They include *Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992). *Estate of Robertson v. Comm'r,* 15 F.3d 779 (8th Cir. 1994), and *Estate of Spencer v. Comm'r,* 43 F.3d 226 (1995). In response to these appellate decisions, the IRS changed Treas. Reg. Sec. 20.2056(b)-7(d)(3)(i) to provide that such contingent elections were valid and would satisfy the marital deduction even if the property for which the election was made passed to or for the benefit of someone other than the surviving spouse.

Thus was born what is known in the industry as the "Clayton Trust." The provisions of the governing document allow the executor, rather than the surviving spouse through a disclaimer, to decide how much should go into the QTIP trust and how much should go to the bypass trust. A typical provision would provide that the residue go into the QTIP trust, but to the extent the executor or trustee does not elect QTIP treatment, the non-QTIPPED property would pass to the bypass trust usually for the spouse and issue.

III. FUNDING FORMULA CLAUSES & THE DEATH OF THE FIRST SPOUSE

The Choice of the Funding Formula

The funding formula is used in the governing document of spousal clients to minimize estate taxes on the first death while utilizing both the deceased spouse's applicable exclusion amount and the unlimited marital deduction. We use a formula to take into account the change in value of assets over time as well as the change in the composition of the assets. These formulae are meant to provide flexibility, but if used without careful thought, they can turn out to be excessively restrictive with unfavorable economic and tax consequences. Very different math equations and different funding amounts will result from the choice of a particular formula. Because the attorney or CPA who is administering the trusts is literally stuck with the funding formula used in the instrument, it is prudent for advisors to review these formula clauses in clients' estate plans while the clients are alive and the clauses can be amended if necessary.

How are these formula clauses chosen and what are the determinants in making the choice? Because there are major differences in the operation and consequences of the various approaches to marital deduction funding, one formula clause may be more appropriate than another in a particular client situation.

Factors Influencing the Funding Choice

Attorneys who draft estate plans use funding formula clauses for optimum use of the applicable exclusion amount and the marital deduction resulting in no estate tax due at the death of the first spouse. Because assets change in character and value over time, these formula clauses accommodate these changes by using mathematical calculations that automatically adjust. Additionally the funding formulae must fit into the broader rules that authorize the unlimited marital deduction under IRC Sec. 2056 as described in Rev. Proc. 64-19. A variety of factors are relevant in evaluating the advantages and the disadvantages of the available funding mechanisms and why an attorney drafting an estate plan would choose one formula clause over another. These factors include:

a. The ease of administration that includes revaluation of assets;

b. Mathematical complications;
c. Concerns about flexibility;
d. Whether the assets are likely to appreciate or depreciate during the period of \ administration;
e. The income tax consequences in the event of appreciation; and
f. Whether there are income tax issues relevant to a particular type of asset such as IRD.

Often the choice rests with the attorney's personal preference and familiarity with a particular funding formula.

Types of Funding Formula Clauses

There are basically two categories of formula clauses for funding purposes:

THE PECUNIARY BEQUEST FORMULA

THE FRACTIONAL SHARE FORMULA

THE PECUNIARY BEQUEST FORMULA

This formula clause historically has been the most commonly used and first funds the lead gift with a specific amount and the other gift with the residue. Its popularity has decreased where assets decline in value during the pre-funding period. Within the pecuniary bequest, there are two types: pecuniary marital formula and reverse pecuniary formula.

The Pecuniary Marital with a Residual Bypass

The Marital Trust shall consist of the minimum dollar amount (if any) of the Decedent's interest in the Trust Estate necessary as a marital deduction to eliminate (or reduce to the extent possible) any federal estate tax by reason of the Decedent's death, taking into account all factors relevant to his estate tax objective including but not limited to: (1) the net value of al/ other property that passes or has passed to or for the Survivor under this Declaration or

otherwise and that qualifies for the federal estate tax marital deduction'; (2) the effects of any other transfers made by Decedent under this Declaration or otherwise, including during Decedent's lifetime; and· (3) all federal estate tax deductions and credits; provided, however, that for this purpose account shall not be taken of any credit for (1) death taxes paid in the estate of one whose death occurs after Decedent's or for (2) any state death tax unless at least some death tax would be payable to the state or states regardless of the federal credit. In determining this dollar amount, final federal estate tax values shall be used, but any transfer by will or otherwise shall be treated as qualifying for the marital deduction if the deduction would have been allowed for that transfer except for (a) disclaimer by the Survivor after Decedent's death or (b) a decision by the Decedent's executor not to make the election provided for in IRC §2056{b)(7) (the "QTIP" election). In satisfying said dollar amount, the Trustee may apportion property to the Marital Share in cash or in kind, in undivided interests, or partly in each, only with assets eligible for the marital deduction; assets eligible for a foreign death tax credit shall be used only if other property of my estate is insufficient.

The Bypass Share shall consist of the balance of the Trust Estate.

If the total estate is on the smaller side and the marital trust is likely to be smaller than the bypass trust, it makes sense to use the pecuniary marital share with a reversionary bypass share. If the marital deduction formula gift is likely to be larger than the bypass trust, the reverse pecuniary formula makes sense. Additionally, if the estate includes qualifying special use valuation property, the pecuniary marital formula should be used rather than the pecuniary bypass formula.

The Valuation Options Used with the Pecuniary/Residual Funding Formula

Within the pecuniary formula is a choice of valuation options. These valuation options are an outgrowth of Revenue Procedure 64-19 that was intended to eliminate perceived abuses in the funding of pecuniary formula marital gifts. These abuses occurred when trustees would fund the marital deduction share at estate tax values with assets that had decreased in value between the date of death and the date of distribution. The appreciated assets would be allocated to the bypass share

and would escape estate taxes on the second death. Revenue Procedure 64-19 requires that in-kind funding of the marital deduction under a pecuniary formula use the fair market value at the date of distribution or be funded with assets that are fairly representative of the post death appreciation or depreciation in the trust estate. This has translated into three basic valuation options that will satisfy the requirements for the unlimited marital deduction. The option chosen determines the date when the asset funding a subtrust is valued. The choice of funding options used with the pecuniary/residual formula clauses includes:

a. ***True Worth – Date of Distribution Value***
b. ***Fairly Representative – Value for estate tax purposes***
c. ***Minimum Worth – Valued at the lesser of estate tax value or the FMV at the date of distribution.***

1. "True Worth" Method and the Pecuniary/Residual Formula

Under the true worth method, the trustee allocates assets to the marital trust having an aggregate value on the date or dates of distribution equal to the dollar amount computed under the pecuniary formula. Assets distributed in-kind must be valued at their date of distribution values. If the assets change in value between the date of death and the date of distribution, this will not generally affect the total amount of the allocation to the marital trust. The exception is where the assets depreciate in value to such an extent below the pecuniary amount. Any appreciation or depreciation will be allocated to the bypass share.

2. Fairly Representative Method and the Reverse Pecuniary Formula

Revenue Procedure 64-19, discussed above, allows allocation of assets at the federal estate tax values rather than date of distribution values. The assets must have an aggregate value fairly representative of the appreciation or depreciation of all the assets. An asset acquired after the decedent spouse's death would use its income tax basis. The trustee shall select property to satisfy this amount so that any appreciation or depreciation that has occurred in the value of trust property between the applicable valuation date and the date of distribution shall be fairly apportioned

between the Marital Share and the Bypass or Credit Share.

3. **"Minimum Worth" Funding**

Assets allocated in-kind shall be considered to satisfy this amount on the basis of their net fair market values as finally determined for federal estate tax purposes. But in no event shall the aggregate value of such assets on the date or dates of distribution be less than this pecuniary amount.

Reverse Pecuniary Formula –Pecuniary Bypass/Residual Marital:

The pecuniary bypass formula is accurately called the "reverse pecuniary" funding formula because it allocates a pecuniary amount to the bypass trust with the residue to the marital gift.

The Pecuniary Bypass (Reverse Pecuniary) with a Residual Marital

> *The Bypass Share (Pecuniary Formula Amount). The Bypass Share shall consist of the maximum dollar amount (if any) of the Decedent's Interest In the Trust Estate that the Decedent may pass to a trust that does not qualify for the: federal estate tax marital deduction without causing any federal estate tax by reason of the Decedent's death, taking into account all factors relevant to this estate tax objective, including but not limited to: (1) other property in the Decedent's gross estate that passes or has passed under this instrument or otherwise and that does not qualify for a federal estate tax marital or charitable deduction; (2) the Decedent's adjusted taxable gifts; and (3) all federal estate tax deductions and credits; provided, however, that for this purpose account shall not be taken of any credit for (1) death taxes paid in the estate of one whose death occurs after mine or for (2) any state death tax unless and to the extent a death tax would be payable to a state or states regardless of the federal credit. In determining the amount of the Bypass Share, final federal estate tax values shall be used, but any transfer by will or otherwise (other than a transfer to the Bypass Trust) shall be treated as qualifying for the marital deduction' if the deduction would have been allowed for that transfer, except for (a) a disclaimer by the Survivor after the Decedent's death or (b) a decision by the Trustee not to make the election provided for in Internal Revenue Code §2056(b)(7). The funding of the Bypass Share may be satisfied in cash or in kind, in*

undivided interests, or partly in each (all subject. however. to the direction in the second sentence of the residuary Marital Share provision below).

The Marital Share shall consist of the balance of the Trust Estate.

This formula provides that the bypass trust has a value equal to the property shielded from tax by the deceased spouse's available applicable exclusion amount. This formula is useful when the non-marital gift will be substantially smaller than the marital gift. It is administratively less burdensome and costly to fund the smaller amount especially where appraisals of difficult-to-value assets are involved. The formula takes into consideration gifts made under the instrument and from other sources in determining the appropriate amount that can pass to the bypass trust to maximize the use of the decedent's applicable exclusion amount.

Valuation Options Used with Reverse Pecuniary Formula

Of the three funding methods described above, only the first two are used with the reverse pecuniary formula:

a. True Worth Method.
b. Fairly Representative Method.

THE FRACTIONAL SHARE FORMULA

The fractional formula approach expresses the bypass share or the marital share as a percentage or fraction of the deceased spouse's estate rather than a dollar amount. Under a fractional formula, the trustee is directed to divide the trust estate into two fractional shares using date of death values. Both shares participate in appreciation of the assets as well as the cost of administration and asset value reductions.

The Marital Share shall consist of the smallest fractional share of the trust estate not otherwise apportioned to the Survivor's Share that, if taken as a federal estate tax marital deduction, will entirely eliminate (or reduce to the maximum extent possible) any federal estate tax on the Decedent's death, after taking into account all factors relevant to this estate tax objective, including but not limited to: (1) all deductions

claimed and allowed In determining the estate tax payable by reason of the Decedent's death, (2) the net value of all other property '(whether or not it is given under this instrument and whether. it passes at the time of the Decedents death or has passed before the Decedent's death to or In trust for the Survivor) that is included in the Decedent's gross estate and qualifies for the federal estate tax marital deduction. If the Survivor disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded; (3) all credits allowed for federal estate tax purposes other than any credit allowable under IRC §2011, unless and to the extent that death tax would be payable to the state or states regardless of the federal credit, as long as no credit is taken into account that results in disallowance of the marital deduction. The term "residual trust estate" means the trust estate remaining after payment of all pecuniary gifts, expenses of administration, debts, and death taxes that are properly chargeable against the residue of the trust estate.

The Bypass Share shall consist of the balance of the trust estate.

After the fraction is determined, a pro rata or non-pro rata funding plan allocates the assets to the marital trust. In establishing this fraction, values as finally determined for federal estate tax purposes shall be used, and the following shall be excluded from the numerator and denominator of this fraction and allocated only to the Credit Trust:

(1) Any assets that are not eligible for the federal estate tax marital deduction;

(2) Any assets for which a credit for foreign death taxes is allowed under the federal estate tax law applicable to the Decedent's estate, unless there is insufficient other property to fully fund the Marital Trust; and

(3) Any insurance on the Survivor's life.

Traditional (Strict) Fractional Share Formula

The traditional fractional share formula allocates a pro rata share of the trust assets to the marital trust based on the determined fraction. This results in a fraction of each asset in the estate being allocated to the marital trust. The remaining fractional share of the trust estate is allocated to the bypass trust.

Non-pro rata Fractional Formula (Pick & Choose)

A "pick and choose" fractional formula allows a non-pro rata allocation of assets in satisfaction of the fractional share marital gift as calculated under the formula. This approach attempts to incorporate the advantages under the pecuniary formula by allowing the trustee the flexibility of choosing whole assets to satisfy the aggregate fractional formula. The marital gift is first determined by multiplying the marital fraction determined under the formula by the date-of-distribution value of the assets available for allocation to the marital gift and the bypass trust. Assets having an aggregate date-of-distribution value equal to this amount are then selected by the trustee to satisfy the gift.

Review Formula Clauses – Switch from Pecuniary/ Residual to Fractional Share or Change Valuation Option

As discussed above, to maximize the use of each spouse's Applicable Exemption Amount (AEA), wills or living trusts of married persons may use a bypass trust (also called credit shelter or exemption trust). This provision sets up a separate trust funded with the exemption amount (or some other amount), often to benefit the surviving spouse while insuring that the decedent spouse's estate uses its exemption amount. With changes in the Applicable Exemption Amount (to $5,120,000 million in 2012) and the size of the estate, make sure that the terms of the clause properly reflect the grantor's intent.

It is important to determine while both spousal clients are alive whether the formula present in the governing document is the best formula. As discussed, Formula clauses are generally divided between "Pecuniary /Residual" or "Fractional Share". Older wills and trusts often favored a pecuniary marital/residual credit formula where valuation took place on the date of distribution. A specific or pecuniary amount (determined at date of death) would be funded into the marital trust and the residue (valued at date of distribution) would flow to the credit share (sometimes called bypass). This formula clause was favored because (1) it was simpler from an administrative viewpoint and (2) if we were in a continuously appreciating market, any appreciation between the date of death and the date of funding the subtrusts would go to the bypass trust and escape estate taxes on the second death. The realities are that asset values have often varied over time making the choice much more difficult.

1. Also under this formula, in a depreciating market, all the depreciation goes to the bypass trust and results in an underfunded bypass trust (which is going the wrong way).

2. There are also pitfalls with all pecuniary/residual formula clauses for income tax purposes that are a trap for the unwary. We are seeing a switch to fractional share formulae to remedy both situations.

The Exempt and Non-Exempt GST Subtrust

Because the bypass and marital trusts only address the issue of estate tax liability, it may be necessary to further divide the subtrusts to accommodate the GST exemption. Where the assets exceed the GST exemption amount (currently $5,120,000), an exempt trust must be created to hold assets that qualify for this exemption. The remainder of the assets are funded into a non-exempt trust where GST tax may still apply.

As of 2003, the basic exclusion amount and the GST exemption have been the same and the bypass trust will need to be divided into exempt and non exempt trusts only when the credit trust exceeds the applicable exclusion amount which would most likely happen where prior gifts have been made for gift tax purposes only or when an IRC Sec. 2032A special-use valuation election is made.

For GST purposes, the GST exemption allocation formula must be identified and generally is the same formula used for the subtrusts in the estate plan. Therefore, if a pecuniary formula is used, Rev Proc 64-19 applies to these trust in the same manner as the marital deduction formula for estate tax. Therefore, the exempt and non-exempt shares are funded either at date-of- distribution values or on a basis that fairly reflects net appreciation and depreciation, from the date of death, of all assets available for funding.

If date-of-distribution values are used and the assets funded into the pecuniary share appreciate between the date of death and the date of distribution, a taxable event occurs. If a "pick and choose" fractional share formula is used in the governing document, funding must be based on the fair market value at the date of funding or determined in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the date of death to the date of funding.

Division of QTIP Trust

If an election is to be made to qualify all or part of the Marital Trust for the federal estate tax marital deduction, and if a reverse QTIP election is to be made, the Marital Trust so qualified shall, if necessary, be divided and established as two separate trusts rather than one in order to permit the reverse QTIP election to be made with respect to one trust (the Reverse QTIP Trust), but not the other (the Nonexempt QTIP Trust). The division shall be accomplished in a manner that complies with Internal Revenue Code Sec. 2642(a)(3).

IV. ECONOMIC IMPACT OF FORMULA CLAUSES (Using 2010 Rules)

COMPARISON CHARTS RE MARITAL DEDUCTION FORMULA

EFFECT OF VALUE CHANGES ON FUNDING Death in 2011

EXAMPLE 1:

DATE OF DEATH VALUE OF DECEDENT'S SHARE= $7,000,000

DATE OF DISTRIBUTION VALUE= $6,500,000

Net decrease in Decedent's Share: ($500,000)

TYPE OF FORMULA	MARITAL TRUST	BYPASS TRUST
a. PECUNIARY MARITAL	$ 2,000,000	$4,500,000
b. PECUNIARY BYPASS	1,500,000	5,000,000
c. FAIRLY REPRESENTATIVE	1,857,050	4,642,950
d. FRACTIONAL SHARE	1,857,050	4,642,950

EXAMPLE 2:

DATE OF DEATH VALUE OF DECEDENT'S SHARE= $7,000,000

DATE OF DISTRIBUTION VALUE= $7,500,000

TYPE OF FORMULA	MARITAL TRUST	BYPASS TRUST
a. PECUNIARY MARITAL	$ 2,000,000	$5,500,000
b. PECUNIARY BYPASS	2,500,000	5,000,000
c. FAIRLY REPRESENTATIVE	2,142,750	5,357,250
d. FRACTIONAL SHARE	2,142,750	5,357,250

As you can see from the brief example above, the choice of funding formula made at the time the estate planning document is drafted can have a significant economic impact on the value of the particular share. It is a result of how appreciation and depreciation are allocated to each share when in-kind assets are used to fund the trusts.

In a situation where the beneficiaries of the Bypass Trust are not the surviving spouse but perhaps the children from a prior marriage, the consequences of the funding formula chosen by the attorney drafting the instrument can be especially dramatic.

Economic Impact of Funding Formula Clauses Where Assets Depreciate During Administration.

EXAMPLE 1

A. Pecuniary Marital Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Distribution (True Worth)
3. Assets depreciate during administration.
4. Pecuniary Marital at Date of Death = $2,000,000 ($7,000,000 - $5,000,000)
5. Date of Distribution:
    i. Pecuniary Marital = $2,000,000 (established at date of death)
    ii. Residual Bypass - $4,500,000 ($6,500,000 - $2,000,000)

Result: Bypass Trust is underfunded due to depreciation of assets during administration.

B. Pecuniary Bypass Formula

1. Formula Clause = Pecuniary Bypass/Residual Marital
2. Valuation Option – Date of Distribution (True Worth)
3. Assets depreciate during administration.
4. Pecuniary Bypass at Date of Death = $5,000,000 ($7,000,000 - $2,000,000)
5. Date of Distribution:
   - i. Pecuniary Bypass = $5,000,000 (established at date of death)
   - ii. Residual Marital - $1,500,000 ($6,500,000 - $5,000,000)

Result: Marital Trust is affected by depreciation of assets during administration.

C. Fairly Representative Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Death (Fairly Representative)
3. Assets depreciate during administration.
4. Valuation Percentages at Date of Death
   - i. Marital Share = .2857 ($2,000,000/$7,000,000)
   - ii. Bypass Share = .7143 ($5,000,000/$7,000,000)
5. Date of Distribution:
   - i. Pecuniary Marital = $1,857,050 ($6,500,000 x .2857)
   - ii. Residual Bypass - $4,642,950 ($6,500,000 x .7143)

Result: Depreciation of assets during administration shared by both trusts.

D. Fractional Share Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Death (Fractions established at death)
3. Assets depreciate during administration.
4. Valuation Fractions at Date of Death
   i. Marital Share = .2857 ($2,000,000/$7,000,000)
   ii. Bypass Share = .7143 ($5,000,000/$7,000,000)
5. Date of Distribution:
   i. Pecuniary Marital = $1,857,050 ($6,500,000 x .2857)
   ii. Residual Bypass - $4,642,950 ($6,500,000 x .7143)

Result: Because fractions are established at date of death on those values, result is the same as the Fairly Representative method.

Economic Impact of Funding Formula Clauses Where Assets Appreciate During Administration.

<u>**EXAMPLE 2**</u>

A. Pecuniary Marital Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Distribution (True Worth)
3. Assets appreciate during administration.
4. Pecuniary Marital at Date of Death = $2,000,000 ($7,000,000 - $5,000,000)
5. Date of Distribution:
   i. Pecuniary Marital = $2,000,000 (established at date of death)
   ii. Residual Bypass - $5,500,000 ($7,500,000 - $2,000,000)

Result: Bypass Trust benefits from appreciation of assets during administration.

B. Pecuniary Bypass Formula

1. Formula Clause = Pecuniary Bypass/Residual Marital
2. Valuation Option – Date of Distribution (True Worth)
3. Assets appreciation during administration.
4. Pecuniary Bypass at Date of Death = $5,000,000 ($7,000,000 - $2,000,000)
5. Date of Distribution:
   i. Pecuniary Bypass = $5,000,000 (established at date of death)
   ii. Residual Marital - $2,500,000 ($7,500,000 - $5,000,000)

Result: Marital Trust is affected by of appreciation of assets during administration.

C. Fairly Representative Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Death (Fairly Representative)
3. Assets depreciate during administration.
4. Valuation Percentages at Date of Death
   i. Marital Share = .2857 ($2,000,000/$7,000,000)
   2. Bypass Share = .7143 ($5,000,000/$7,000,000)
5. Date of Distribution:
   i. Pecuniary Marital = $2,142,750 ($7,500,000 x .2857)
   ii. Residual Bypass - $5,357,250 ($7,500,000 x .7143)

Result: Appreciation of assets during administration shared by both trusts.

D. Fractional Share Formula

1. Formula Clause = Pecuniary Marital/Residual Bypass
2. Valuation Option – Date of Death (Fractions established at death)
3. Assets depreciate during administration.
4. Valuation Fractions at Date of Death
   i. Marital Share = .2857 ($2,000,000/$7,000,000)
   2. Bypass Share = .7143 ($5,000,000/$7,000,000)
5. Date of Distribution:
   i. Pecuniary Marital = $2,142,750 ($7,500,000 x .2857)
   ii. Residual Bypass - $5,357,250 ($7,500,000 x .7143)

Result: Because fractions are established at date of death on those values, result is the same as the Fairly Representative method.

V. SPECIAL ISSUES WITH FORMULA CLAUSES

Does the Formula Still Work?

Formula clauses in spousal estate plans provide for the change in value of the assets between the time the estate plan was executed and when the formula clause takes effect at the first death. They also satisfy the requirements for the IRC Sec. 2056 Unlimited Marital Deduction. While there are several types of formulae, they all serve to fund one of the shares with the decedent's maximum applicable exclusion amount. As we know, this has increased over the years from $600,000 to the present amount of $5,120,000.

Care must be taken that a trap for the unwary doesn't lurk in a client's formula clauses such that the surviving spouse is inadvertently disadvantaged or disinherited by the automatic workings of a formula clause. This could happen especially in a situation where someone other

than the surviving spouse is named as the beneficiary of the exemption amount, (Herb & Edith and Alice & John).

The automatic increase in the applicable exemption amount has created this trap lurking in the language of the Will or trust. Because of the way the formula clauses work, the "greatest amount necessary to result in no federal estate tax due on the first death" is funded into the credit shelter/bypass trust. This could result in all the decedent spouse's assets being funded into the credit shelter/bypass trust and nothing passing outright or in the marital trust to the surviving spouse.

Even if the surviving spouse is the trustee and the income beneficiary of this trust, the surviving spouse does not own these assets and all decisions made regarding these assets must be made in a fiduciary capacity mindful of the rights of the remainder beneficiaries.

The Story of Herb & Edith

Some older plans exist where parents with adult children have allocated the applicable exemption amount outright to the children with the remainder to the surviving spouse. When the applicable exclusion amount was $600,000, $650,000, $675,000 or $1,000,000, this made sense and was a reasonable allocation. Now reaching $5,120,000 in 2012, the formula language could fund all the assets into the credit shelter trust leaving nothing going outright to the surviving spouse. This was the situation with Herb and Edith. Their estate plan left the exclusion amount of the first spouse to die to their adult children. At the time the estate plan was executed, this was $600,000. When Herb died in 2012, this amount was $5,120,000. Therefore, all of Herb's assets were funded into the bypass share for the children and included a portion of the personal residence. The children became co-owners of the residence with Edith and were alarmed at the maintenance costs of the residence. The children wanted Edith to sell the house and move into a condominium and she didn't want to and they began asserting their rights as co-owners. Because of the formula allocation, Edith had lost autonomy over the home she had lived in with Herb for over sixty years.

The Story of John & Alice

In blended family situations, the results can be disastrous. John and Alice had been married since 2002. They met in a Yoga class that Alice was teaching. It was the first marriage

for Alice, but John was previously married and has children from that marriage (who happen to be significantly older than Alice). John brought about $5.0 million in separate property assets to this marriage. Alice, a free spirit, owns few assets (other than her yoga mat).

John created a separate property trust just after he married Alice when the Applicable Exclusion Amount was $1.0M. Using the formula clauses, he intended to leave his kids $1.0M (the applicable exclusion amount) outright and $4.0M in trust for Alice (utilizing the marital deduction) resulting in a no tax estate on death of the first spouse. The intent was to provide financial security to Alice for her life.

John was killed in a car accident in June of 2011. His estate had remained at $5M. But, between the time he created the trust and the time he died, the Applicable Exclusion Amount had automatically increased from $1.0M to $5M.

Implementing the formula clause drafted into his trust created in 2002, his entire estate now goes to his kids, and Alice is left with nothing. Alice has been inadvertently disinherited not by John but by the formula clause that should have been reviewed and updated. While Alice has recourse through the courts, this would result in expense, time and stress at an already difficult time.

SPECIAL INCOME TAX RULES RELATED TO SUBTRUST FUNDING

1) Satisfaction of a pecuniary bequest with appreciated property or IRD = sale or exchange.
2) Estate's satisfaction of pecuniary bequest with depreciated property = allowable loss.
3) Funding of formula share carries out DNI.
4) Subtrusts within an administrative trust are treated as separate shares (IRC Sec. 663).

Calculate the Gain or Loss on Funding the Pecuniary Share

In funding the subtrusts using a true-worth pecuniary formula, it is important to remember the fiduciary income tax rule:

Satisfaction of a pecuniary bequest with appreciated property or IRD results in a sale or exchange and the recognition of gain.

Reg. Sec. 1.661(a)-2(f)(1). 1.1014-4(a)(3); Rev Rul 56-270, 1956-1 Cum Bull 325; Rev Rul 60-87, 1960-1 Cum Bull 286; Kenan v Commissioner (2d Cir 1940) 114 F2d 217.

If "date of distribution" values are used in either a pecuniary marital or a pecuniary bypass share, and the assets have appreciated during administration, there is gain to the residual share on funding the pecuniary share. If an item of IRD is used to fund a pecuniary bequest, the built-in income tax is immediately recognized. Of particular concern are retirement assets that are IRD, installment notes and other types of compensatory IRD. In a pecuniary bypass (reverse) formula, if the marital share pays the tax on the gain, the marital share will be reduced by the amount of taxes paid. In funding a pecuniary subtrust share, this income tax rule can result in unanticipated and unfortunate consequences to the trustee who is unaware of the rule.

Funding Pecuniary Share with Depreciated Property

In a trust situation, although gain is recognized on funding a pecuniary bequest with appreciated property, any loss is disallowed under the related party rules of IRC Sec. 267. However Sec. 267 has a specific exception to the disallowance rule where an estate is involved. In an estate situation, if a pecuniary bequest is satisfied with depreciated property, a loss is allowed. Therefore, making the Sec. 645 election is crucial in taking advantage of this important exception.

Additionally, aggregation of gains and losses are not allowed so in the trust situation, even if a trust has overall depreciation in excess of appreciation, gain would still be recognized on the appreciation while the loss is disallowed under IRC Sec. 267.

Distributions to the Subtrusts Carry Out DNI

A trust is considered to "carry out" DNI if the trust gets a distribution deduction and the income is taxed to the recipient beneficiary. A specific bequest under IRC Sec. 663 is an exception to this rule. If a distribution is a specific bequest, any tax consequences are borne by the trust and the recipient beneficiary receives the distribution as a gift.

The general rule in trust administration is that a distribution from an estate or administrative trust to a subtrust carries out DNI under IRC Sec. 643(a) because such a share does not constitute the type of specific bequest described in IRC Sec. 663(a)(1). A pecuniary share is not considered a

specific bequest under IRC Sec. 663 because there are so many variables in determining the pecuniary share as to take it out of the precise definition of "specific bequest" where the amount must be ascertainable at the date of death. Therefore, in the year that the subtrusts are funded, the distribution from the administrative trust to each subtrust carries out any taxable income for the current year.

A pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation still constitutes a separate share and carries out DNI. If the share earns no income, this results in DNI being equal to zero.

Conclusion:

Funding issues in spousal trust administration are complicated and contain a series of moving parts. They provide added complexity to the myriad of accounting and tax issues that accompany even a simple fiduciary administration. Proper funding of subtrusts on the death of the first spouse requires a clear understanding of the rules and the funding provisions in the governing document as well as detail accounting and modeling of assets and values.

ESTATE PLANNING ISSUES AND UPDATES

CHAPTER 3 FAMILY LAW & OTHER ISSUES

A. Change in Family Status

Times change, circumstances change, people and their relationships change and each can have a significant impact on an estate plan. It is always important to determine whether a change in the family status has occurred. These changes in family status are very important in determining whether the existing plan still works or whether the entire plan or some of the provisions should be changed.

a. Has there been a marriage or divorce or a pending divorce?

b. Has a post nuptial or ante-nuptial agreement been signed?

c. Has a new child or grandchild been born?

d. Was there a death out of order?

e. Is there an age gap between sets of children that require special attention?

f. Is there a member of the family with a disability?

B. Blended Families

If a client has been married previously and has children from a prior marriage, additional complexity is added to the estate plan. Often a client will want to provide for a current spouse but also make provisions for children from a prior marriage. This must be discussed openly with clients and the provisions in the estate plan must be carefully drafted to reach the intended result.

C. Selection of Guardian

No matter what the size of the testator's estate, he or she should nominate a guardian of the person for minor children.

a. Parents are the natural guardians of their minor children but if the parents are deceased or otherwise unavailable, a guardian must be appointed by the court to take custody of the minor and provide for the child's needs.

b. A guardian for minor children should be nominated by a parent in the estate planning

documents.

c. Guardianship of minor children is generally divided between guardian of the " person" and guardian of the "estate".

d. The guardian of the "person" generally has responsibility for the care, custody, control and education of a minor;

   (i) A minor's needs typically cover a wide spectrum, ranging from companionship and personal care to financial support and skilled management of property. However, the two most common events triggering the unavoidable need for formal appointment of a guardian are school enrollment and the need for medical treatment requiring parental consent.

e. The guardian of the "estate" is responsible for the management and control of the minor's property.

f. The nomination of a guardian should be properly coordinated with the financial arrangements the testator makes for the minor either in the will or outside it (possibly in the trust document).

g. A deceased parent's clear cut expression of choice of guardian in the will, together with the naming of alternatives, serves the following purposes:

   (i) It reduces the delay in the appointment of the person of a minor after the parent's death;

   (ii) It spares the minor the agony of a family dispute over such an appointment; and

   (iii)It allows the parents to expand or limit the guardian's authority to care for the minor.

h. Because of the importance of the guardian, the testator should nominate an alternate or successor guardian. Minors are subject to legal restrictions in dealing with property. Therefore, if it is desired to leave property to a minor, the parent may appoint a guardian of the estate of the minor, or may leave the property in a testamentary trust for the child.

D. Designation of Executor or Successor Trustee

The executor or trustee is the person or entity nominated by the testator or trustor to carry out the directions in the will or trust and to dispose of the property according to its provisions.

a. Important Considerations:

(i) Is the named executor or successor trustee alive and willing to serve?

(ii) Does this person have the maturity, competence and temperament to serve?

(iii) Is there a backup person or institution named?

(iv) Does the executor have a conflict or is there hostility between the executor and the other beneficiaries?

b. Selection Considerations:

(i) Selection of an individual, including the surviving spouse, can be advantageous if the selected individual is familiar with the financial status of the decedent and the needs of the family.

(ii) Selection of a corporate fiduciary can have advantages in providing continuity in the administration of the estate. In addition, the corporate fiduciary may be more capable in handling investments and maintaining impartiality.

(iii) Co-executors or co-trustees may be favored where the testator or trustor wishes to combine familiarity with assets and family needs and an expertise in handling estates.

(iv) Because the appointed executor or trustee may be unable or unwilling to serve or continue to serve, the testator or trustor should appoint one or more alternate or successor executors or trustees.

(v) An executor is legally entitled to a fee, which is a deductible expense of administration on either the estate tax or income tax return, and includable income for the executor. Secs. 2053(a)(2) and 642(g).

E. Divorce & Family Law Issues

a. Valuations: With the economy in a tailspin, valuation issues will come to the fore especially in divorce property settlements. Spouses owning business interests will argue that historical data is not fully relevant to current value in light of uncertainty, changes to the economy and so forth.

b. Discounts: Discounts are a critical factor in valuations in jurisdictions which permit them in divorce cases. Recent market turmoil may legitimately increase the discounts on certain asset valuations. Unique factors certainly exist in the current market. Higher discounts might be justified. Asset values may be depressed as a result of the greater discounts. The impact of this on matrimonial settlements could be substantial.

(i) Prenuptial Agreements: Review client prenuptial agreements. The valuation of assets that formed the basis of a client's prenuptial agreement may have changed so dramatically as to undermine the entire basis for the agreement.

(ii) 529 Plans and Children's Trusts: It is common to establish 529 plans or trusts for children, especially when a couple is divorcing. Removing assets into a separate entity or plan can minimize the likelihood of the ex-couple feuding over decision making (especially if an independent trustee is designated). However, tumultuous economic conditions raise a host of issues.

(iii) Debts: When times are good clients tend to obsess over the division of assets. The recent economic crisis may change the dynamic to a greater focus on debts and liabilities. Recent developments could have an especially devastating impact on clients who fought bitterly to win control over a particular asset only to realize a Pyrrhic victory. So your client fought and sacrificed to win the family home. Their perception of this assuredly appreciating asset was behind the fervor. Now, the mortgage is more than the reduced value of the house.

(iv) Lifestyle: How do you evaluate a married couple's lifestyle for purposes of determining expenses? The magnitude of the recent economic

developments may have forever changed the standard of living the couple could continue in the future if they were not divorcing. Financial projections for the divorce negotiations, as well as for the future determination of post-divorce expenditures, savings and gift planning, will be different.

(v) Business Contractions: With economic problems growing, your client might be inclined to contract his or her business or professional practice.

(vi) Property and Casualty Insurance: People too often cut the wrong corners when they feel pinched, frequently including insurance. Advise your clients to have an insurance consultant review property, casualty, liability and other insurance coverage. If the clients dropped (or perhaps the ex-spouse simply stopped paying without informing your client) key insurance coverage, a casualty could jeopardize the entire marital estate. Economic downturns require more vigilance as to insurance coverage.

(vii) Asset Allocation: Determine an optimal allocation and periodically rebalance. It is also pretty common knowledge that most divorces decimate any intelligent asset allocation.

Family Support Obligations

Death does not relieve a parent of support obligations for minor children. This is because a parent's statutory child support duty runs to the child and is not extinguished by the parent's death. This must be taken into consideration where clients have remarried but have minor children from a prior marriage. There are family protection statutes in California that will take precedence over a client's estate plan and can often change the plan dramatically. Therefore, it is important that clients in this category address support obligations in their estate plans.

Life insurance on the parent's life is a good solution where child or spousal support must be secured regardless of the life expectancy of the payor. A life insurance trust is often used for this purpose and provides not only the support necessary but possesses excellent estate planning opportunities in that the insurance proceeds are not includable in either the donor's or the beneficiaries' estates.

Determining the Character of Property

The determination of the character of property is essential to an effective estate plan. In the spousal situation, it is essential to fully and correctly understand how title to property is held. This can impact whether the property follows the provisions in the will or trust or transfers via a contractual arrangement such as joint tenancy or community property with rights of survivorship. If the issue of title comes up after a decedent has died, it is a good sign that a conflict among beneficiaries is about to occur. As mentioned previously, clients often don't understand real estate issues or terms of art and much time and confusion can be saved by obtaining the latest transfer documents to determine ownership rights.

Post-Nuptial Transmutation/Marital Property Agreements

It is very important to determine whether spousal clients have entered into any type of post-marital property agreements where property characterized under California law would be transferred between the spouses by agreement. Such a transfer is termed a "transmutation" which is a transfer of property between spouses where the underlying character of the property changes as a result of the transfer [*Estate of MacDonald* (1990) 51 CA3d 262]. Property can be transmuted from community property to separate, and from separate property to community. However, in all cases under Family Code Sec. 852(a), a writing is required.

In order to have an effective transmutation, there must be an "express declaration" indicating a clear showing of a party's intent to alter the affected property character. Often these documents are executed during the estate planning process with no thought of the impact that could occur on a subsequent divorce. Two fairly recent cases, *In re Marriage of Starkman* (2005) 129 CA4th 659 and *In re Marriage of Holtemann* (2008) 162 CA4th 1175 reflect the importance of these issues when a marriage ends in divorce and not death. In *Starkman*, the couple were married for 13 years and the husband brought significant separate property to the marriage. Neither spouse worked and the coupled lived on the earnings from the husband's assets. After the birth of their daughter, the couple executed a joint revocable trust. The trust document indicated that all property in the trust would be community property unless it was identified as separate property. The separate property of the husband was not specifically identified in the trust or in the general assignment executed contemporaneously with the trust

document. The husband's assets were subsequently transferred to the trust. The couple separated and began divorce proceedings. The wife contended that the husband's property had been transmuted to community property when the assets were transferred into the trust. The trial court entered judgment in favor of the husband and held that because the husband had not stated any express declaration of transmutation, the property retained its separate character. The wife appealed. The appellate court affirmed the lower court's finding in favor of the husband and found that while the "express declaration" did not require use of the terms "transmutation" or "community property, it was not valid unless made in writing by an express declaration expressly stating that a change in the characterization or ownership of the property was being made. The Court held that the estate planning instruments and stock brokerage transfer forms together did not establish a transformation of the husband's separate property to community property.

In re Marriage of Holtemann came to the opposite conclusion based on a set of very different facts. In this case, the spouses executed an estate plan and included in the plan was a document entitled "Spousal Property Transmutation Agreement" in which the husband changed the character of his property from separate to community. The estate planning attorney who drafted the plan explained the legal consequences of this document and they waived representation by separate counsel. Upon separation and divorce, the husband tried to argue that this document was for estate planning purposes and not divorce. The trial court found that under the express terms of the Transmutation Agreement, the husband had transmuted his separate property identified in Exhibit A to community property. This holding was affirmed on appeal and the appellate court found that the Transmutation Agreement had unambiguously stated that a transfer in character had taken place through the provisions of the agreement. The court rejected the husband's argument in full and found that an unambiguous contractual agreement cannot be binding for estate tax purposes and not for family law purposes because such a result would benefit the husband.

These cases indicate the power of estate planning documents in the family law context and how the two areas of law are interrelated. Such interrelationships indicate that estate planning advisors must recognize the importance of family law issues during the planning process in the event that the marriage does not last until death of one of the spouses.

The Poorer Spouse's Bypass Trust (Where Portability not Chosen or Available)

There are situations in spousal estate planning where one spouse comes into the marriage with significantly more assets and maintains these assets throughout the marriage as separate property. If the other spouse has significantly fewer assets, it is often difficult for that spouse to create a plan that takes advantage of the applicable exclusion amount. A remedy for this problem is for the more affluent spouse to simply gift assets to the poorer spouse in an attempt to equalize the estates. This is possible without the imposition of gifts taxes through the unlimited marital deduction. But if this is not the first marriage for the spouses or the assets are difficult to transfer, often this solution is not acceptable.

> **Example (Assume constant 2010 Estate Tax Rates and Exclusions)**
> John and Judy are married and John's estate is worth $7.12 M while Judy has assets of of $200,000. Judy dies in 2010 and most of her applicable exclusion amount of $5.0M is wasted. John dies two years later, his applicable exemption amount shelters $5.12M of his assets, but the remaining $2.0 M are taxed at the 35% tax rate.

Instead, John could have transferred half his estate to Judy while she was alive so each of their estates would be worth $3.5M and on Judy's death, her share of the assets could fund a Bypass Trust with John as beneficiary. While this sounds like a perfectly reasonable solution, John might be unwilling to permanently transfer half his assets to Judy for fear they may later divorce.

A solution to this dilemma is for John to transfer his assets into a revocable living trust and grant Judy a formula general testamentary power of appointment (GPOA). In this manner, John retains control over the assets which includes the right to revoke or amend the trust. If Judy dies before John, her personal representative has the right to appoint an amount up to her unused estate tax exemption into a bypass trust for the benefit of John. John is granted rights in the bypass trust but does not have powers that would cause inclusion in his estate. This strategy has been approved by PLRS 200101021, 200210051,200403094 and 200604028. The exercise of the GPO on Judy's death creates a completed gift from John to Judy that qualifies for the federal gift tax marital deduction. The amount transferred from John is removed from his estate for

estate tax purposes and while included in Judy's estate, is sheltered from estate tax by her applicable exclusion amount. John can be both beneficiary and trustee of the bypass trust so long as the power to make distributions is limited by an ascertainable standard and can have an inter vivos and testamentary limited power of appointment over the principal of the trust. The end result is that John retains control over his wealth, but the couple take full advantage of both their exemptions.

If John dies first, more traditional estate planning techniques can be used. A bypass and marital trust can be created for the benefit of Judy with the remainder going to the beneficiaries that John chooses. This strategy is not without risks. Judy must be a citizen or additional planning is necessary to qualify for the unlimited marital deduction. Additionally, there is the chance that Judy would fail to exercise the GPOA or even worse, exercise it in favor of someone other than John.

More creative applications can be made of this strategy between spouses where control is not an issue. This may include situations where there are special assets held by spouses or even non-spouses (same sex partners).

Example

A married couple each owns $5.12M of separate property. The husband owns a portfolio of stocks and the wife has an IRA worth $5.12M. If wife dies first and holds a general testamentary power of appointment, she can direct the husband's assets to fully fund a bypass trust while her IRA is left directly to the husband and qualifies for the marital deduction. This would allow the husband to rollover the wife's IRA.

ESTATE PLANNING ISSUES AND UPDATES

CHAPTER 4 CALIFORNIA ISSUES AND UPDATES

A. Disinheritance Clauses

Disinheritance is an act by which the owner of an estate deprives a person who would otherwise be the owner's heir of the right to inherit. The rules for spouses are found in CA Prob. C Sec. 21610 and for children in Sec. 21620. A disinheritance clause in a will or trust simply states that the grantor does not wish for one or more specific persons to take any portion of the property passing under the governing document. This clause is only effective as to the property disposed of by the instrument and cannot prevent a grantor's heirs at law from taking under the intestate succession statutes. Therefore it is important that a will or trust have a residuary clause that passes property in the event that the named beneficiaries fail to take.

The circumstances under which a disinheritance clause is necessary to give effect to the grantor's intentions are specific and limited. A disinheritance clause by its nature is effective only against persons who are not provided for in the will and who would otherwise be entitled to claim a share of the decedent's estate. Under the omitted heir statutes applicable to the estates of persons who die on or after January 1, 1998, the only persons entitle to claim a share of the estate if they are not provided for are as follows:

a. A surviving spouse who married the testator after the execution of all of the testator's testamentary instruments , including wills and revocable instruments (CA Prob. C Sec. 2610);
b. A child born or adopted after the execution of all of the testator's testamentary instruments, including wills and revocable trust instruments; or
c. A child living at the time of all of the testator's testamentary instruments effective at the time of the testator's death, including wills and revocable trust instruments, if the testator failed to provide for the child solely because the testator believed the child to be dead or was unaware of the child's birth.

Because the omitted heir statutes have limited application, the circumstances under which it is necessary to disinherit heirs are also limited. Thus it is not necessary to disinherit a spouse who married the testator before the execution of the testator's will or before the execution of any

revocable trust instrument since such a spouse does not meet the statutory definition of an "omitted spouse" under CA Prob. C Sec. 21610. Also a child who to the parent's knowledge was born before the execution of the will or revocable trust instrument will not qualify as an "omitted heir" and need not be disinherited. Having said this, it is often common practice to include a disinheritance clause in every will or trust when such a result is intended.

There are generally two types of disinheritance clauses:

a. General clauses disinheriting all persons not otherwise provided for in the will; and

b. Clauses that specifically disinherit one or more named individuals or a narrowly defined class of persons.

c. A will or trust may contain either or both types.

Disinheritance of the Spouse

If a decedent fails to provide for a spouse who married the decedent after the execution of the decedent's testamentary instruments, the omitted spouse will generally be entitled to receive a statutorily prescribed share of the decedent's estate under CA Prob. C Sec. 216010. In order to effectively exclude such a spouse the following provisions must be included in the decedent's estate planning documents;

a. A properly drafted disinheritance clause;

b. Provide for the spouse by a transfer outside of the estate passing by the testamentary instruments [Prob. C Sec. 21611(b)]. There must be an intention expressed in the testamentary documents that such a transfer is in lieu of a transfer in the testamentary documents;

c. By obtaining a valid agreement in which the spouse waives the right to share in the decedent's estate.

When an unmarried person executes an estate plan, this person should understand that unless there is some language in the estate plan evidencing the intent to disinherit a spouse married after the will is executed, the spouse may claim a share of the client's estate and thus disrupt the provisions of the estate plan. Therefore, it is very important that upon marriage, a client has his or her estate plan reviewed. If the goal is to not include the new spouse in the

estate plan, this must be clearly stated. A general "catch-all" provision has been found not to be sufficient when it comes to a surviving spouse (*Estate of Turney* (1951) 101 Cal.App.2d 720, *Estate of Axelrod* (1944) 23 Cal 2d 761). However a will that recognizes the possibility of an upcoming marriage but specifically states that the provisions of the current will stand and not be revoked has been held to withstand a claim by the surviving spouse (*Estate of Lapidus* (1954) 123 Cal.App. 2d 289). The burden of proof is on the proponents of the will or trust and not the spouse.

If a spouse is disinherited by a plan executed after marriage, the spouse is not protected under the omitted heir statutes and is not entitled to claim any share of the testator's estate merely by virtue of the fact that he or she was not mentioned in the will or trust. The surviving spouse is, of course, entitled to his or her share of the community property and quasi-community property and to any family allowance available under CA Prob. C Secs. 6540 –6545. The will or trust can remain silent as to this issue. It is also unnecessary to specifically provide that a spouse will be disinherited in the event of dissolution or annulment. A dissolution or annulment of marriage after execution of an estate plan will automatically revoke any testamentary disposition of property or other provision made in favor of the former spouse [CA Prob. C Sec. 6122(a)].

B. California's No-Contest Legislation

On July 22, 2008, Governor Arnold Schwarzenegger approved a bill which substantially changed the enforcement of no-contest clauses with respect to any instrument such as wills and trusts, whenever executed, which became irrevocable on or after January 1, 2001. The law became effective on January 1, 2010.

A no-contest clause is also referred to as an "in terrorem" clause is to prevent or discourage a beneficiary under a will or trust from bringing a contest action. It is a provision in otherwise valid instruments that, if enforced, penalizes beneficiaries if they file a contest with the court. If the beneficiary loses the contest, the provisions treat that beneficiary as if he or she had predeceased the decedent. Existing law provides that a no-contest clause in a will or a trust is generally enforceable in California. They are also favored by public policy as discouraging litigation and giving effect to the purposes expressed by the testator. A no-contest clause imposes a condition on the gifts and dispositions in the will and the rights of a named devisee depend on the devisee's acquiescence in the terms of the will or trust. Such clauses are only

effective against those beneficiaries named in the governing documents. Persons not named in the will or trust are able to bring a contest and have nothing to lose because the documents make no provision for such person. A no-contest clause is only effective if the contest is unsuccessful. If a contesting beneficiary is successful in the contest, the no-contest clause is as void as the will (*Estate of Baker* (1917) 176 Cal. 430).

The prior statutory scheme attempted to enumerate actions that *would not* constitute a contest. The new statute enumerates actions that *will* constitute a contest. Under the new scheme, any direct contest, as defined, that is brought with probable cause does not violate the no-contest clause. Because this new scheme provides more clarity on what constitutes a contest and what does not, it does away with declaratory relief actions under CA Prob. C Sec. 21320. This is one of the biggest changes under the new law. Under former Prob. Code Secs. 21320 – 21322, a beneficiary of an instrument containing a no-contest clause could petition the court for a determination of whether a contemplated action would violate the no contest clause.

What Constitutes a Contest After January 1, 2010

The new law defines what constitutes a contest and broadens the probable cause exception to the application of the no-contest clause. As discussed above, declaratory relief was repealed in its entirety. Common law governs to the extent that the statute does not apply, the statutes apply regardless of a contrary provision in the instrument, and a no-contest clause is to be strictly construed.

A "contest" is defined as a pleading filed with the court by a beneficiary that would result in a penalty under a no contest if the no contest clause is enforced. A "direct contest" is defined under CA Prob. C Sec. 21310(b) as a contest that alleges the invalidity of a protected instrument or one or more of its terms, based on the following grounds:

a. Forgery;
b. Lack of due execution;
c. Lack of capacity;
d. Menace, duress, fraud, or undue influence;
e. Revocation of a will under Prob. C Sec. 6120, revocation of a trust under Sec. 15401 or revocation of an instrument other than a will or trust pursuant to the procedure for revocation that is provided by statute or by the instrument; and

f. Disqualification of a beneficiary under Prob. C Sec. 6112 (interested witness) or Sec. 21350 (disqualified person).

"Pleading" is defined as a petition, complaint, cross-complaint, objection, answer, response or claim under Prob. C Sec. 21310(d). A new addition to the law is a definition of "protected instrument" that the no-contest clause applies to the instrument in which is contained and an instrument that exists on the day that the instrument containing the no contest clause is executed. Therefore, a no contest clause cannot apply to future instruments, only to instruments in existence at the time that the instrument containing the no contest clause is executed. There is no definition of "indirect contests" because under the new law a no contest clause is only effective again a direct contest without probable cause and against only two other types of actions, property ownership challenges and creditor's claims that are expressly described in the no-contest clause.

CA Prob. C Sec. 21311 describes three exclusive types of actions to which a no-contest clause will apply. First, a direct contest that is brought without probable cause is subject to the no-contest clause. This means that if the contestant has probable cause for his contest, the no-contest clause does not apply. "Probable cause" exists if, at the time of filing a contest, the facts known to the contestant would cause a reasonable person to believe that there is a reasonable likelihood that the requested relief will be granted after an opportunity for further investigation or discovery [Prob. C Sec. 21311(b)]. "Reasonable likelihood" has been interpreted to mean that more than merely possible, but less than "more probable or not." For example, if a contestant had probable cause to believe that there had been undue influence, even if the contestant does not prevail, the no-contest clause is not applied and the contestant will not be penalized.

The second category when a no-contest clause will be enforced is a pleading to challenge a transfer of property on the grounds that it was not the transferor's property at the time of the transfer if the no-contest clause expressly provides for application to such a pleading [Prob. C Sec. 21311(a)(2)]. The statute omits probable cause from this proceeding so that having probable cause to bring such a pleading does not protect the contestant from the no-contest clause. If a contestant brings an action alleging that the property did not belong to the transferor,

and the no-contest clause does not mention such a pleading explicitly, the no-contest clause does not apply and the contestant may bring such a pleading without penalty. On the other hand, if the no-contest clause does mention such a pleading, the fact that the contestant may have had probably cause does not prevent the no-contest clause from being applied and the contestant will suffer the penalty described in the clause, regardless of whether the contestant prevails or not. In this manner, a transferor can force an election between taking under the instrument and filing a pleading to challenge a transfer of transferor's property to someone else. The onerous effect of this provision can be mitigated by the drafter including the "probable cause" standard in the instrument.

The last category of the when the no-contest clause will be enforced is with the filing of a creditor's claim or prosecution of an action based on it, if the no-contest clause expressly provides for application to such a claim or action. Having probable cause to bring such a claim or action does not protect the contestant from the no-contest clause. Thus, if a contestant files a creditor's claim and the no-contest clause does not explicitly prohibit such a claim, the no-contest clause does not apply and the contestant may file the creditor's claim without penalty. However if the no-contest clause does prohibit such a creditor's claim, the fact that the contestant may have had probable cause does not prevent the no-contest clause from being applied and the contestant will suffer the penalty described in the clause.

Because the new law does not allow a no-contest clause to apply to future instruments, each amendment of an existing instrument should contain its own no-contest clause where one is desired. An existing no-contest clause can be incorporated by reference but it is preferable to include a no-contest clause that can stand on its own in each instrument. It is not adequate to rely on the statement in an amendment that the settler confirms and ratifies the original trust agreement

C. Amendments to Uniform Principal and Income Act

Fiduciary Accounting for Partnership Assets Held by Trust under Pre and Post 2000 Uniform Principal & Income Act

Facts:

1. Irrevocable Trust X requires that all income be distributed currently to income beneficiaries A & B.
2. State law follows Uniform Principal and Income Act and no special provisions in trust.
3. Trust X holds 50% general partnership interest in Y Partnership.
4. Partnership has following financial information for trust:
   i. Investment in Partnership: $500,000
   ii. Book Income: $100,000
   iii. Distribution to Trust: $40,000
   iv. Distribution to Beneficiary: $40,000
   v. Sale of Trust's Partnership Interest for $600,000.

Issues:

1. **How does the trustee account for the partnership's income and loss in 1998 under CA Prob. C Sec. 16308?**
2. **How does such accounting impact the financial and income tax situation to the trust as well as the income and remainder beneficiaries?**
3. **How does the trustee account for the same information in 2000 under CA Prob. C Secs. 16350?**

Accounting for Partnership Interests Held by Estates and Trusts

CA Prob. C Sec. 16350 significantly altered the accounting rules for partnership interests previously found in the prior law under CA Prob. C Sec. 16308. The change in law in 2000 can significantly alter what beneficiaries will be receiving under current law as compared to prior law. It is very important to identify the situs of the trust and the law that governs the trust's administration. It is also important to determine whether special provisions have been drafted into the governing instrument that would take precedence over the statutory accounting rules.

Background for Former CA Prob. C Sec. 16308

CA Prob. C Sec. 16308 followed the accounting model for determining a trust's income from a partnership interest. "Income" was defined as the trust-partner's share of partnership income. Sec. 16308 read as follows:

"...the net profits of the business shall be computed in accordance with recognized methods of accounting for a comparable business. Net profits from a business are income. Net losses from a business do not reduce other trust income for the fiscal or calendar year during which they occur but shall be carried into subsequent fiscal or calendar years and reduce the net profits of the business for those years"

This accounting model correlates with the legal rights and obligations of partners which are different from those of corporate shareholders. This GAAP-based accounting model has many similarities to the income tax treatment of partnerships.

a. For tax purposes, a partner in a partnership is taxed on the Schedule K-1 income that reflects the partner's pro rata share of taxable income. This taxable income is recognized by the partner regardless of distributions made by the partnership to the partner.
b. However, for tax purposes, a distribution by the partnership reduces the partner's adjusted basis in his partnership basis.
c. If significant distributions are made to a partner in a year when the partnership suffers a taxable loss, the partner does not recognize any taxable income.
d. The tax rule clearly indicates that partnership income operates independently from the rules for distributions to the partners.

CA Prob. C Sec. 16308 followed the same share-of-income concept or equity method, which provides that income for the trust-partner is the partner's share of partnership income or loss on a GAAP basis.

a. There may or may not be book/tax differences.
b. With proper information from the partnership, tax basis financial information can be converted to GAAP basis, if necessary.

c. Just like tax accounting, the partnership's distributions to the trust/partner did not affect the trust-partner's income under CA Prob. C Sec. 16308.

d. Such distributions instead reduced the carrying value of the partnership interest on the books of the trust.

e. This reduction was reflected on the trust's books in the balance sheet account titled "investment in partnership."

f. Therefore, prior rules for determining income from a partnership paralleled the income tax rules, with the trust-partner's income being its share of the partnership's GAAP income and the distributions from the partnership applied as a reduction in the trust's investment in the partnership account.

Investment in Partnership	
Beginning Balance:	Purchase Price of Partnership on Acquisition
Increases:	
Annual share-of-Income	Calculated on a GAAP basis
Decreases:	
Annual share-of-loss	Calculated on a GAAP basis
Distributions by Partnership	Cash distributions from Partnership
Ending Balance:	**Investment in Partnership**

Problems With Prior Law

As the problem example reflects, if a simple trust's partnership income is $100,000 and its actual distribution to the trust is $40,000, the amount required to be distributed to the beneficiary is $100,000 and a shortfall in cash at the trust level occurs.

In any year under CA Prob. C Sec. 16308 that the trust's share of partnership income exceeded distributions, the trust was not be able to pay the beneficiary the full amount due. If the trust has other liquid assets, the shortfall may not prove to be such a concern. However, if the partnership asset was the only asset in the trust, this shortfall could create a real problem for the trustee.

CA Prob. C Sec. 16350

Under CA Prob. C Sec. 16350, the law is much simpler and applies to all distributions from entities. A distribution from a partnership is considered income unless it is "in-kind" or in partial or full liquidation of the partnership interest. The new fiduciary accounting law has brought the treatment of partnership interest in sync with that of corporate distributions. The new law quickly becomes more complicated, however, by this notion of "deemed partial liquidation" which is defined as partnership distributions that are "greater than 20% of the entity's gross assets." Such distributions are classified as receipts of principal. Also, any distribution that is termed by the partnership as a liquidating distribution is allocated to principal.

Under CA Prob. C Sec. 16350, the problem of a trust's shortfall to handle the distribution to the income beneficiary has been corrected. However, it has been replaced with a tax problem to the trustee.

Comparison of Old and New Law

In comparing the fiduciary accounting treatment of a trust's ownership interest in a general partnership asset under the different accounting rules, there are distinct economic differences between the two rules. Under old Sec. 16308, the income beneficiary would receive $100,000 but only $40,000 under new Sec. 16350. This difference in benefits would be material and significant to the income beneficiary. Under the new rules, there are tax consequences to the trust that are discussed below. These are issues that should be discussed with the grantor of a trust when the estate plan is being created and the grantor's desires should be stated in the governing documents. It could be something as simple as making the distributions to the current beneficiaries discretionary rather than mandatory and allowing the fiduciary the flexibility of making distributions based on the current economic circumstances. The power to adjust and unitrust provisions also create some flexibility and serve as a solution under the appropriate circumstances. As more families use special use entities in the way of family partnerships and LLC's, it is important that these issues be considered during the planning process.

<u>Update on Distributions from Entities</u>

CA Prob. C Sec. 16350 is based on the model code enacted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) at UPIA Sec. 401. Sec. 401 addresses distributions from entities and sets out 4 mechanical rules that have solved some problems and created some new ones. A distribution can be from a corporation, a mutual fund or more problematic on a K-1 from a partnership, LLC or S Corporation especially where the trustee does not possess the power to adjust.

The 97 UPIA/Sec. 16350 classifies all entities the same and sets forth the following rules:

a. A distribution of cash not in liquidation is allocated to income.

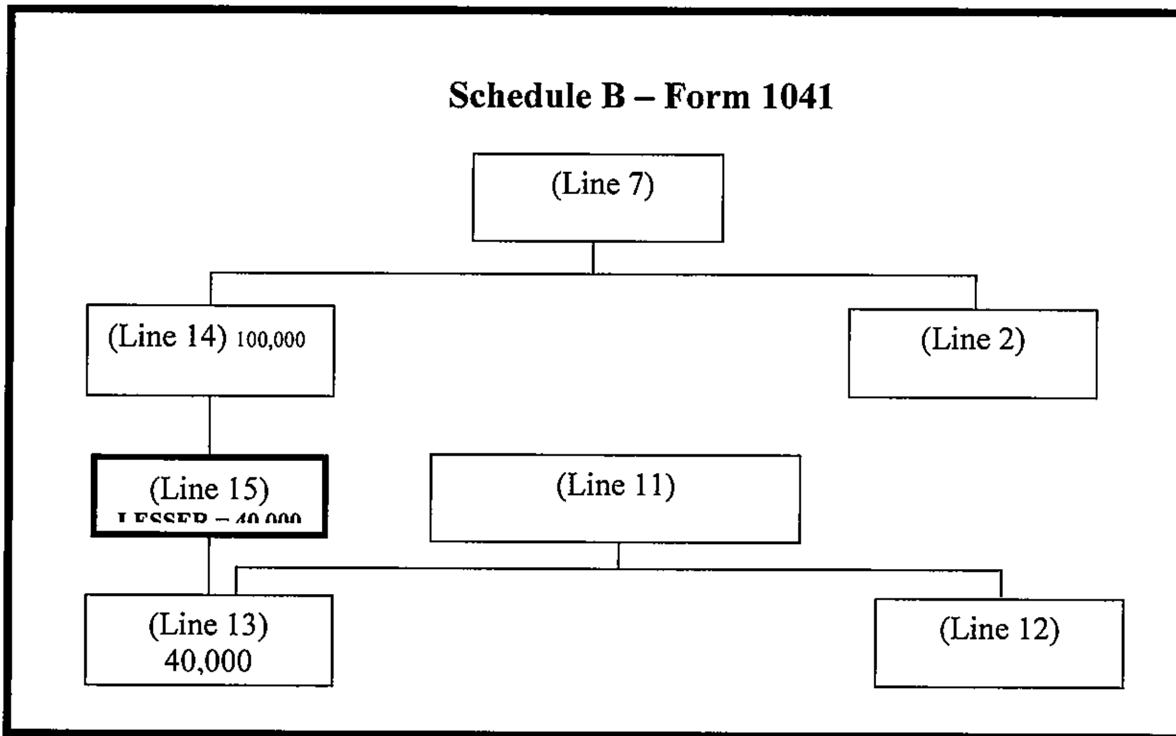
b. A distribution in-kind is allocated to principal.

c. A distribution in full or partial liquidation is allocated to principal.

d. A distribution is deemed to be in partial liquidation and allocated to principal if it exceeds 20% of the investment in the entity.

So revisiting the previous example to a situation of the income-only trust where the trust is a partner in a partnership. The partnership issues a K-1 that shows $100,000 of taxable income with a cash distribution to the trust of $40,000 (probably to cover the taxes produced on the K-1.) How is this $40,000 allocated between principal and income under CA Pro. Code Sec. 16360 and UPIA Sec. 401?

If you follow the mechanical rules set out in Sec. 16350 (UPIA 401), the entire cash distribution of $40,000 would be allocated to income and distributed out to the income beneficiary with a corresponding $40,000 DDNI. This leaves $60,000 at the trust level, generating tax without funds to pay the tax.



Unless the trustee takes some further action, the tax reimbursement will be distributable to the beneficiary depriving the trust of the ability to pay tax on its income unless it has other cash available as corpus. If the trustee exercises the power to adjust and transfers the $40,000 back to principal, this reinstates the trust's ability to pay its taxes on the full $100,000 of taxable income. This can only be done through the application of CA Prob. C Secs 16335, 16336, 16374 and 16375 (UPIA Secs. 103, 104, 505 and 506). If the state where the trust resides has not adopted some version of '97 UPIA or the power to adjust, such a reasonable result is not possible.

The ABA, ACTEC & the AICPA have been looking at this problem with Sec. 401 at the Model Code level for quite some time and a committee from the ABA and ACTEC submitted suggested revisions to Sec. 401 to NCCUSL. The AICPA also submitted comments to these revisions. Such revisions included:

a. Revising the 20% rule for partial liquidations so that distributions of accumulated income will retain its character even if it exceeds 20%. Under the current rules, if a large distribution is made by a trust to make up for prior years with no income

distributions, this 20% rule would characterize the distribution as principal. This was the case when Microsoft declared its first dividend in many years. In actuality, the distribution was income from prior years and the revisions suggest that such distributions be considered income even if they exceed 20% of the entity's gross assets. This could be accomplished either by eliminating the 20% rule all together or perhaps creating a special power to adjust between principal and income to make up for lack of prior distributions.

b. Providing better coordination between the power to adjust under Sec. 104 and the power to adjust for taxes under Sec. 505. Such revisions under Sec. 505 would include requiring a tax required to be paid by a trust on the trust's share of an entity's taxable income be paid:

(i) From income to the extent that receipts from the entity are allocated only to the income;

(ii) From principal to the extent that receipts from the entity are allocated only to principal;

(iii) Proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(iv) From principal to the extent that the tax exceeds the total receipts from the entity.

c. Additionally, providing more flexibility for the trustee in determining the proper classification of receipts between income and principal has been suggested. Simple is nice but doesn't always work. This would include the addition of sections under Sec. 401 to provide the trustee the ability to look through the entity to determine the underlying source of the monies received.

Algebraic Formula Adopted by NCCUSL in 2008

In July of 2008, the UPIA Model Code was amended by NCCUSL and the text of the amendments can be found on the NCCUSL website. California incorporated these amendments into law in October 2009 in AB 1545. The amendments focused on Sec. 16371 (UPIA Sec.409) and the 90/10% principal/income allocation contained in the original provisions. It also incorporated some of the suggested entity revisions but only under Sec. 16374 (UPIA Sec 505)

of the tax section. The revisions under Sec. 16374 (UPIA Sec. 505) suggest the use of algebraic formula to determine the net amount to the income beneficiary and retain funds at the trust level to pay taxes.

Going back to our example of a partnership's Schedule K-1 to a trust that reflects $100,000 of taxable income and a distribution of $40,000, the formula would read as follows:

D = (C-R*K)/(1-R)

D = Distribution to income Beneficiary
C = Cash paid by the entity to the Trust
R = tax paid on income (assume 35%)
K = Entity's K-1 taxable income

D = (40,000-.35*100,000)/(1-.35)
D = (40,000 – 35,000)/.65
D = $7,692

Taxable Income Per K-1	**$100,000**
Payment to Beneficiary	**7,692**
Trust's Taxable Income	**92,308**
35% Tax Rate	**$ 32,308**

Partnership Distribution	**$40,000**
Fiduciary Tax Liability	**(32,308)**
Payable to Beneficiary	**$ 7,692**

Sec. 16361/UPIA Sec. 409 2008 Amendment

a. CA Prob. C Sec. 16361 (UPIA Sec. 409) amendment serves to resolve issues brought about by IRS Revenue Ruling 2006-26 and assist separate funds within a trust in qualifying for the IRS estate tax marital deduction safe harbors.

b. The problem occurs when a person designates a trust for the benefit of his or her spouse as beneficiary of his or her IRA or similar retirement plan rather than designating the spouse individually as the beneficiary. This is often done when:

(i) This person has children from a prior marriage;

(ii) Where the spouse is incapacitated;

(iii) There are creditor or spendthrift issues; or

(iv) Asset management is desired.

Non-Marital Trust

a. If the payment is characterized as interest, dividends or a payment made in lieu of interest or dividends, this payment is allocated to FAI with any balance allocated to principal.

b. If no part of the payment is characterized as interest or dividends, 10% is allocated to FAI and 90% is allocated to principal (the 10/90 allocation ratio).

c. Required minimum distributions are allocated according to the 10/90 allocation rule.

d. Non required payments are allocated to principal (lump sum distributions, etc.)

Marital Trusts

a. A retirement asset is generally bequeathed outright to a surviving spouse unless there is a compelling reason to hold it in trust. This is because the SS can roll over the plan assets into his or her own IRA and maximize the income tax deferral by allowing the SS to use the Uniform Lifetime Tables.

b. Compelling reasons to use a trust: blended family, complicated beneficiary designations, incapacity, management issues and asset protection. The estate planning objectives must outweigh the benefit of the income tax deferral offered by a roll over.

c. In a marital trust, the surviving spouse must be entitled to all of the trust's income for life. Although a very common drafting approach is to require that all income is paid to the surviving spouse no less frequently than annually, relevant regulations require only that the surviving spouse have the right to withdraw the income no less frequently than annually. Reg. Sec. 20.2056(b)-5(f)(1), (8), and 20.2056(b)-7(d)(2).

d. When an IRA or other retirement arrangement (a "Plan") is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction.

e. In the original version of Sec. 16361/409, the Sec. 16361/409 attempted to satisfy the marital deduction requirements that all income be available to SS for life in order to qualify for the marital deduction under IRC Sec. 2056.

   i) The 2056 Regs. define income under IRC Sec. 643(b);

   ii) This leads to the state statutory accounting rules under Sec. 16361/409 or the specific state statute. (10/90% allocation rule).

   iii) There was even a savings clause that specifically mentioned the marital deduction and gave the trustee authority to allocate more of a payment to income so as not to run afoul of the marital deduction. It stated that receipts would be reallocated to income to the extent necessary to qualify for the marital deduction.

f. Well this didn't work because in 2006, the IRS issued Rev. Rul. 2006-26 clarifying its opinion on when such a Plan payable to a trust qualifies for the marital deduction. It flatly rejected the 10/90 allocation rule and the savings clause as insufficient to qualify for the marital deduction. It said that, as written, Sec. 16361/409 does not cause a trust to qualify for the IRS' safe harbors.

i) The IRS ruling directly criticized the UPIA's original formula for allocated IRA distributions between principal and income even though there was language in the original statute directed to the marital deduction. It should be noted that Rev. Rul. 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans.

ii). Rev. Rul. 2006-26 provided a safe harbor for IRAs and defined contribution retirement plans that are payable to a marital deduction trust to qualify for the marital deduction, but only if the trust satisfies two requirements.

- If and to the extent that the trustee does not withdraw and distribute the Fund's income to the surviving spouse, the surviving spouse must be entitled to require the trustee to distribute the fund's income; and
- The fund's income must be determined as if the fund itself were a marital trust. It should be noted that a safe harbor is not the only way to qualify for the estate tax marital deduction in such circumstances. However in light of the importance the Service placed on these issues by going to the trouble of issuing a Revenue Ruling, there was a legitimate concern expressed by many attorneys that they might draft estate plans that do not comply with the safe harbor.

iii). Without necessarily agreeing with the IRS position in that ruling, Revised Sec. 16361/409 is designed solely to put the UPIA's provisions in line the safe harbor rule of the unlimited marital deduction under IRC Sec. 2056. It set up a mechanism for determining the income from assets defined under Sec. 16361/409.

iv). The Ruling states that the spouse must have the right to require that the plan's income be distributed to the trust, and that this income and income from other assets in the trust be distributed in turn to the spouse.

UPIA Sec. 16361/409(f) – the trustee will determine the internal income of each separate fund.

a. Upon request from SS, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust.

b. The trustee shall allocate to income to the extent of the internal income and distribute that amount to the surviving spouse.

c. The balance shall be allocated to principal.

d. Upon request of the SS, the trustee shall allocated principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

UPIA Sec. 16361/409(g) – if the trustee cannot determine the internal income of a separate but can determine the value of the separate fund, the internal income is deemed to be (insert number between 3 - 5%) of the fund's value.

a. Use the most recent statement of value preceding the beginning of the accounting period.

b. If the trustee cannot determine either the internal income or the fund's value, the internal income is deemed to equal the product of the interest rate and the present value of the expected future payments as determined under Sec. 7520.

Retroactivity of the Amendment

a. Because of income tax and distribution issues, Sec. 16361/409 was made retroactive to Jan. 1 of the year in which the changes were made if the marital trust has been funded for more than one taxable year.

b. If the marital trust is not funded until the year of enactment, or will not be funded until a later year, these changes are retroactive to the date of death.

All of this is good news. The 97 Model Code (adopted by 43 states and counting) is a vast improvement over the 1961 Act but has a way to go. It is a work in progress and it's good to see that progress is being made. Even though NCCUSL has made these changes, they will

next have to be adopted into the state law of each state to have full force and effect. California had already revised its 90/10% allocation rule in 2006 for both marital and non-marital trusts and its wholesale adoption of the 2008 amendments actually created a step backward in California law that needs to be revisited. However, the new entity rules improve California rules on distributions from entities. California has historically been very proactive in adopting some new versions of the model code provisions into state law.

Remember if all else fails, the standard in the fiduciary world is: **What is Reasonable and Equitable?**

ESTATE PLANNING ISSUES AND UPDATES

CHAPTER 5 SPECIAL ADMINISTRATIVE ISSUES IN RECESSIONARY TIMES

Apparently the recession officially began in December 2007 but was widely announced in December, 2008. "A recession is a significant decline in economic activity, measured by the job market, inflation-adjusted income, the total amount of goods and services produced by a country and other indicators. It begins when a country reaches a peak of economic activity and ends when the country reaches its trough. The period on the way up from the trough to the peak is known as an expansion." (NY times, 12/1/08)

A. Characteristics of the Current Recession:

a. Substantial decline in real estate values and corresponding substantial increase in foreclosure rates and vacancy rates;

b. Significant decline in value of marketable securities;

c. Extraordinarily low interest rates;

d. Enormous inventory of unsold residential property;

e. Unavailability of credit for business startup, acquisition, and expansion, real estate acquisitions and refinancing, home-building, etc.

f. Ultra-high unemployment figures.

A recession has a direct impact on the estate planning and probate practices because they are centered on the administration and disposition of wealth. Because the valuation and distribution of such wealth is the ultimate goal of estate planning, a recession can directly impact the ease with which an estate or trust is administered, resulting in unique and complex issues. Fiduciaries of estates or trusts that are negatively impacted by the recession must often deal with insufficient assets and reduced asset values that must be allocated among and between the competing interests of both creditors and beneficiaries.

B. Insolvency Issues and Creditors vs. Beneficiaries

While trusts and estates, unlike individuals and corporations, are not afforded any protections under the bankruptcy statutes, a fiduciary takes on a role that is similar in nature to

that of a debtor in possession or a bankruptcy trustee. A fiduciary owes a duty to both beneficiaries and creditors and is often exposed to risks of liability with respect to both. *Nathanson v. Superior Court (1974)* 12 Cal.3d 355, 366; *Larrabee v. Tracy* (1943) 21 Cal2d 645,650; *Estate of Erwin (1953)* 117 Cal.App.2d 203,204.

It is important to thoroughly analyze the liabilities of the trust or estate in order to determine whether the creditor has recourse against the assets and whether these assets generate enough revenue to cover their operating expenses and debt service. Difficult decisions must often be made by the fiduciary whether to default on the obligation and permit the creditor to foreclose on its security interest in the property or arrange for the creditor to accept a deed in lieu of foreclosure.

a. Beneficiaries may oppose such action by the fiduciary in the hopes that the economy will improve and the property will reclaim its prior value.

b. If the subject property is a specific devise to a specific beneficiary, the residuary beneficiaries may insist that the property be sold to satisfy its debt rather than have the residue charged with the shortfall.

c. If the creditor has recourse against the trust or estate assets for any deficiency following a foreclosure sale of the property, the beneficiaries may criticize the fiduciary for not selling the property sooner when perhaps the sales value was higher resulting in a lower deficiency judgment.

d. If the fair market value of the property is less than the outstanding debt, the fiduciary may want to attempt to restructure the debt in a manner that is beneficial to both the creditor and the estate or trust. Perhaps such a restructuring would include an incremental lowering of the interest rate for a stated period (i.e. 5 years) or a payment deferral of any payment for a stated period. Any such "workout" should be subject to court approval on a petition with notice given to all beneficiaries and creditors in order to protect the fiduciary.

e. There are statutory provisions under CA Prob. C Secs. 11420 & 19001 that provide ordering rules for the payments to creditors of the estate or trust and the requirement that secured creditors of a probate estate timely file creditor's claims (also applies to trusts which elect to provide notice to creditors).

C. Illiquidity Issues

Lack of Income Productivity from Specific or General Pecuniary Devises

Specific devises under a will or trust do not bear interest, but do entitle the devisee to post-death income on the specifically devised property less directly attributable expenses during the period of administration. If the income is insufficient to cover the expenses, the deficiency attributable to the first year after the decedent's death is paid from the estate or trust assets. Thereafter, the amount paid by the estate is a charge against the devisee's share of the estate and the fiduciary has an equitable lien against the specifically devised property for the amount paid. These rules are described in CA Prob. C Secs. 12002 and 16340(a)(3).

Timely Payment of Pecuniary Bequests

Unless otherwise provided in the governing instrument, a general pecuniary bequest, whether outright or in trust, bears interest at 7% if not distributed within one year of the decedent's death. [CA Prob. C Secs. 12003 & 16340(b)] The rate of simple interest is three percentage points below the legal rate on judgments which is currently 10%. (CA Prob. C Sec. 12001 & CCP Sec. 685.010).

In a recession, a fiduciary may not be able to make the pecuniary gift within the twelve month period thereby triggering the interest rules. Because the interest rate of 7% is much higher than a market rate earned on the estate assets, the beneficiaries may take issue with the fiduciary's delay and seek to surcharge the fiduciary for incurring unnecessary interest expenses. The fiduciary should not be liable for such expenses to the estate if the fiduciary can establish that the delay was justified because of uncertainty about whether there would be sufficient funds to satisfy all debts, taxes and administrative fees and expenses.

The interest paid to beneficiaries for delayed pecuniary bequests is not deductible to the estate or trust as it is considered nondeductible personal interest under IRC Sec. 163(h). TAM 9604002 also held that interest paid by an estate on the delayed distribution of a pecuniary bequest was not deductible as an administrative expense under IRC Sec. 2053 for estate tax purposes. The TAM held that such interest was not deductible because the interest payment was intended to compensate the beneficiary for the delay in distribution and therefore payment of statutory interest should not be viewed as an administrative expense as it was in the nature of a payment of income to estate beneficiaries. However, an alternate conclusion was reached by the court in *Turner v U.S.*, 306 F.2d 668 (N.D. Tex. 2004), where the court held that under the facts of that case, statutory interest on a delayed pecuniary devise was a deductible administrative expense under IRC Sec. 2053.

Payment of Debts, Expenses & Taxes

a. Priority in Estate Situations – Debts are prioritized by statute under CA Prob. C. Sec. 11420 among classes of debts and debts owed to the United States or the State of California have certain preferences:

i. Expenses of Administration

ii. Obligations secured by mortgage, deed of trust, or other lien, so far as they may be paid out of the proceeds of the property subject to the lien. If the proceeds are insufficient to satisfy the debt, the part of the obligation remaining unsatisfied shall be classified with the other general debts.

iii. Funeral expenses.

iv. Expenses of last illness.

v. Wage claims.

vi. General debts, including judgments not secured by a lien and all other debts not included in a prior class.

Unless otherwise provided by statute, the debts within each class are without preference or priority over one another. If there is insufficient property to pay all debts of any class in full, each debt is that class is paid a proportionate share of the available property.

Federal and State Preferences - Debts owing to the United States or the State of California receive priority under:

a. California Revenue & Taxation Code Sec. 19516 – priority of claim for taxes under Personal Income Tax Law;

b. 31 U.S.C. 3713 – priority of claim for debts due the United States;

c. IRC Sec. 6324(a)(2) – subject to special limitations, a trustee is personally liable for unpaid estate taxes.

d. United States tax obligations have priority over California tax obligations per *Estate of Jacobs (1943)*, 61 Cal.App.2d 152;

e. United States tax claims have preference over last illness expenses per *Estate of Muldoon (1954)*, 128 Cal.App. 2d 284.

D. Valuation of Assets for Purposes of Distribution – The recession can have a dramatic impact on distributions provisions in an estate plan.

> **Example** - A decedent spouse's estate plan provides a gift in trust for the surviving spouse for life with the children and charities as the remainder beneficiaries. The governing document provides a gift of $600,000 to the charity with the remainder to the children. At the first death, the value of the trust assets was $1,000,000 but only $500,000 at the surviving spouse's death. During the period of administration, the value of the assets rebounded to $800,000. The issue for determination is what amount the children receive. Is it zero or $200,000?

Salvation Army v Price (1995), 36 Cal.App.4th 1619 held that the interest of the beneficiaries vested on the date of the surviving spouse's death. In the example, the FMV of the assets was $500,000 which is less than the pecuniary gift to the charity. As a result, the gift to the children was extinguished on that date and could not be reinstated once the value of the trust had increased to an amount in excess of the amount due the charities.

Satisfying Devises with In-Kind Distributions of Property

Because a recession often leaves the trust or estate with liquidity issues, most available cash is needed to pay debts, expenses and taxes. This leaves little cash to make distributions and often a fiduciary is reluctant to sell property at a drastically reduced price to fund these obligations. Therefore, the fiduciary often elects to distribute in-kind assets in satisfaction of these gifts.

This may create conflicts among and between beneficiaries in regard to the value of the assets they receive. There may be complaints that the asset they or another beneficiary received is over or under valued. If the estate is already strapped for cash, spending money on expensive appraisals is probably discouraged.

In this situation, an agreement by all parties concerned as to the property distributed and its value is one method to avoid a later conflict. Another method is to put all in-kind assets into a special use entity such as an LLC and to distribute each beneficiary a member interest in the entity. Provisions in the operating agreement could require agreement on value before any asset is sold so that no beneficiary suffers the risk of an incorrect valuation or the continued decline in the value of any particular asset. If all the beneficiaries agree to sell the assets and distribute the proceeds proportionately, they may do this.

Sale of Residuary Assets to Pay Expenses of Administration, Taxes and Debt

Fiduciaries should sell only those assets that are absolutely necessary to sell for the purpose of paying expenses of administration and general debts of the estate chargeable to the residue. Adequate appraisals of the assets should be obtained as well as the consent of all interested parties. Court approval may be required before the sale.

If funds are needed to pay expenses during the first year on debts or taxes ultimately chargeable to specifically devised assets, the fiduciary should first determine whether the devisee of the assets would object to the sale. Additionally, it should be determined whether the specific devisee would be willing to personally bear the expense of these assets during administration. If the devisee is unwilling, perhaps a sale of the asset is the only recourse available to the fiduciary.

The governing document must be consulted to determine whether there are specific provisions or limitations regarding any such sale.

E. Abatement of Gifts – Abatement is the reduction or complete elimination of a gift of property passing from a decedent as a result of the charging of expenses, debts, and taxes against property of the estate and the satisfaction of gifts of higher priority.

a. CA Prob. C Sec. 11420 describes how gifts are to abate and shares of beneficiaries abate to the extent necessary for all purposes including the payment of debts, expenses and charges.

b. Under CA Prob. C Sec. 21402, beneficiary shares abate in the following order:

i. Property not disposed of by instrument such as through intestacy;
ii. Residuary gifts;
iii. General gifts to non-relative;
iv. General gifts to relatives;
v. Specific gifts to non-relatives; and
vi. Specific gifts to relatives.

c. Additionally, shares abate within each class on a prorate basis under CA. Prob. C Sec. 21403.

d. In periods of recession there arises more situations where abatement is an issue and various problems can arise for the fiduciary. For instance, Prob. C Sec. 21400 provides that despite the statutory abatement scheme, "if the transferor's plan or if the purpose of the transfer would be defeated by abatement as provided" in the statutory scheme, "the shares of beneficiaries abate as is necessary to effectuate the…plan or purpose." In this situation either a petition for instructions would protect the fiduciary's decision or the disclosure on an accounting sent to all interested parties.

CHAPTER 6 TOOLS TO ASSIST IN THE ESTATE PLAN REVIEW

Located in these seminar materials are some tools that will help you implement an estate planning review program for your clients. These tools are intended as a starting point for you and to save you time. They may be revised and tailored to your individual client's needs. Often times, just getting the conversation started is all that it takes for a client to participate in an estate planning review and possible update.

1. **REVIEW CHECKLIST**

2. **CLIENT QUESTIONNAIRE**

3. **ESTATE PLANNING SELF-ASSESSMENT**

4. **CLIENT FINANCIAL ORGANIZER**

ADVISOR'S REVIEW OF THE CLIENT'S WILL & TRUST DOCUMENTS

A CHECKLIST

1. Verify that the statement of domicile is accurate.
2. Confirm that all of the family members are named.
3. Verify that successor fiduciaries are named.
4. Find a separate provision for disposition of tangible personal property, and discuss possible family problems.
5. Determine whether real estate located out of state will require an ancillary probate proceeding. Can it be avoided putting those assets in a living revocable trust?
6. Discuss whether the bequest to the spouse should be outright or in trust.
7. Determine whether either spouse has been married previously and whether there are children from the prior marriage(s).
8. Make certain that any bequest to the surviving spouse qualifies for the marital deduction.
9. Determine the character of marital assets as community or separate.
10. Determine whether there has been a change in the family status.
11. Ascertain whether a family member has a disability.
12. Check that the bypass trust will not be included in the gross estate of the surviving trust.
13. Analyze whether the marital formula clauses in the estate plan still work in light of the increased applicable exemption amount.
14. Ascertain citizenship and domiciliary information from the clients, their children and their choice of successor fiduciaries.
15. Obtain life insurance information.

16. Discuss the timing, control and amounts of bequests to children and grandchildren.

17. Watch for possible generation skipping transfers.

18. Verify that bequests to charity qualify for a charitable deduction and continue to meet the client's objectives.

19. Discuss the selection and responsibilities of the executor and the trustee.

20. Read each power granted to the executor and trustee to ascertain whether tax planning opportunities are considered. An important power is the power to make non-pro rata distributions.

21. Determine whether the tax apportionment clause, if any, distributes the tax burden unequally or if it reduces the marital or charitable deduction.

22. Determine whether there are any state estate tax consequences.

23. Make certain that the simultaneous death clause, if any, provides for the most beneficial marital deduction.

24. Discuss the selection, powers and responsibilities of a guardian and possible "compensation."

25. Verify that the statement of the applicable law for the trust takes advantage of the local law.

26. Watch for trustee powers that are too broad and create adverse tax consequences such as loss of the marital deduction or inclusion in the beneficiary's gross estate.

27. Discuss whether income payments from each trust should be mandatory or discretionary.

28. Verify whether gifts in trust qualify for the annual exclusion for gift tax purposes.

29. Determine whether a power of appointment is a general power or a limited power.

30. Find the spendthrift clause.

31. Review the No-Contest Clause.

32. Ascertain whether the trust is revocable or irrevocable.

33. Discuss the advantages and disadvantages of a durable power of attorney for financial affairs.

34. Stress the importance of a durable power of attorney for health care.

35. Where is the central repository for the family documents and papers?

36. Ascertain whether a gifting strategy would benefit the client.

37. Work closely with the client's attorney.

IRS CIRCULAR 230 DISCLOSURE: To comply with IRS Regulations, we inform you that any discussion of U.S. federal tax issues in this correspondence (including any enclosures) is not intended or written to be used, and cannot be used, (1) to avoid any penalties imposed under the Internal Revenue Code, or (ii) to promote, market, or recommend to another party any transaction or matter addressed herein.

ESTATE PLANNING CLIENT QUESTIONNAIRE

Date Prepared: ____________________

Name(s): __________________________________

Address: ________________________

____

Telephone: ____________________

Dates of Prior Wills or Trusts: __________________

FAMILY FACTS

1. **Your Name:** ____________________________

   Other names: _________________________

   Spouse's name: ________________________

   USA Citizen: _________________________

2. **Residence address:**

   Street: ______________________ City: _____________________

   County: _____________________ Zip Code: ________________

3. **Phone:**

   Residence: _________________

   Office: ______________________

   Children:

   Name: __________________________ Date of Birth: ____________

   Name: __________________________ Date of Birth: ____________

   Name: __________________________ Date of Birth: ____________

4. **Prior marriages if any:**

5. **Children, if any, of prior marriage, if any:**

6. **Spouses of children:**

   Name of child: Name of spouse:

7. **Deceased children, if any**

8. **Grandchildren:**

   Names: Name of spouse:

10. **Marriage Date:** **Place:**

11. **Birth Date:** **Spouse:**

12. **Social Security Number:**

    Yours: ______________________________

    Spouse's: ____________________________

In regard to my estate plan, I am very concerned about the following:

____

____

____

____

____

I/We would like to make the following gifts:

To: Name / Address	**Description of Gift**

The Remainder of Our Estate Should Be Distributed as Follows:

Name / Address	**Description / Percentage**

Trustee/Executor Designation

First Successor	**Address**

Second Successor	**Address**

Attorney-in-Fact for Power of Attorney for Healthcare

	Address

Assets

Cash & Cash Equivalents

Description	Market Value	Cost	Debt (if any)

Real Property

Description	Market Value	Cost	Debt (if any)

Stocks

Description	Market Value	Cost	Debt (if any)

Mutual Funds

Description	Market Value	Cost	Debt (if any)

Bonds

Description	Market Value	Cost	Debt (if any)

Business Interests

Description	Market Value	Cost	Debt (if any)

Partnership Interests

Description	Market Value	Cost	Debt (if any)

Artwork & Other Collectibles

Description	Market Value	Cost	Debt (if any)

Retirement Plans

Description	Market Value	Cost	Debt (if any)

Other Assets (i.e. Life Insurance)

Description	Market Value	Cost	Debt (if any)

Liabilities

Description	Market Value	Cost	Debt (if any)

Prior Gifts Greater than $13,000 per year/per person

Person Gifted	Amount	Date	Gift Tax Return Filed

Guardianship Provisions (if minor children involved)

Name of Guardian: ______________________________

Successor Guardian: ______________________________

Financial Provisions to be provided to Guardian: ______________________________

____

____

Other provisions regarding guardianship:

____

____

____

Other Comments or Concerns

____

____

____

____

____

____

____

____

Estate Planning Self-Assessment

MY/OUR ASSETS

ASSETS	Single Grantor	Decedent Spouse	Surviving Spouse
Residence			
Second Home, If any			
Bank Accounts			
Brokerage Accounts			
Retirement Accounts, such as 401(K), 403(B), and IRAs			
Life Insurance (insert the amount of proceeds includible in your estate)			
Tangibles Personal Property (jewelry, furniture, autos, etc.)			
Partnership Interests/Business Interests			
Other			
Add back prior gifts			
Total			
Assume 2% Administration Expenses	( )	( )	
Net Estate			
Subtract $5,120,000 (Unused Applicable Exclusion Amount)	$ (5,120,000.00)	$ (5,120,000.00)	
Subtract Marital Deduction		( )	
Net Taxable Estate			
Multiply above figure by roughly 35% - this is the estate tax owed at your death without planning	X 35%	X 35%	
Total Estate Tax Due at Your Death			

6-12

DOCUMENT CHECKUP

	YES	NO
Do you have a will or living trust?		
Do you have a Living Will and Health Care Proxy?		
Do you have a Power of Attorney?		
Have you reviewed the beneficiary forms for your retirement accounts?		
Is your life insurance in an irrevocable trust?		
Have you reviewed the titling of your assets?		

Financial Organizer

Important Records and Documents

of:______________________________

Address:______________________________

Phone Number:______________________________

E-Mail:______________________________

Important Records and Documents

of: ______________________

KEY CONTACTS			
ADVISOR	Name	Address	Phone Number
Attorney			
Accountant			
Executor/Successor Trustee			
Power of Attorney-Agent			
Financial Advisor			
Guardian for Minors			
Primary Care Physician			
Pediatrician/Specialist			
Other Physician			
Religious Representative			
Dentist			
Veterinarian			
Funeral Home			
Telephone Provider			
Cellular Phone Provider			
Cable Provider			
Gas Company			
Religious Representative			
Electric Company			

FAMILY AND FRIENDS

Name	Address	Relationship	DOB	DOD

Important Documents	Provider Contact Information	Location of Documents
Social Security Card		
Birth Certificate		
Passport/Citizenship (naturalization) papers		
Driver's License Number and Expiration Date		
Adoption Papers		
Marriage Certificate		
Prenuptial Agreement		
Divorce or Separations Papers		
Military Discharge Papers		

Passwords to Information	Passwords	Comments/ Hints

Important Documents	Provider Contact Information	Location of Documents
Safe and Combination		
Safe Deposit Box and Key		
Real Estate Deeds		
Motor Vehicle Title		
Other Tittles of Ownership		
Appraisal & Inventory of Valuable Items		
Prior Years' Federal and State Income Tax Returns		
Federal/State Gift Tax Returns		
Property Tax Records		

Banking Documents	Provider Contact Information	Location of Documents
Account Statements		
Checking Statements		
Savings Statements		
Money Market Account Statements		
Credit Union Account Book or Statements		
CD Statements		
Credit Card Statements		
Debit Card Statements		
Online Bill Paying Information		

Estate Planning Documents	Provider Contact Information	Location of Documents
	Estate	
Last Will and Testament/ Revocable Trust (original)		
Advanced Health Care Directive HIPAA Release		
Durable Power of Attorney Financial Management		
Burial Instructions		
Cemetery Plot Deed		
Prepaid Cremation Papers		
Funeral Home Preference and Information		
Letter of Instruction to Executor/Executees		
Death Certificate		
Certification of Trust		
Transfer Documents		

Estate Planning Documents	Provider Contact Information	Location of Documents
	Insurance	
Life Insurance Policy		
Beneficiary Forms for Insurance Policy		
Group Life Policies		
Health and Accident Insurance Cards and Claims Record		
Mortgage Insurance Policies		
Travel Insurance Policies		
Property and Casualty Policy		
Veterans Administration Insurance Policy		
Disability Insurance Policies		
Long-Term Care Insurance Policy		

Personal and Charitable Trusts

		Beneficiaries
Irrevocable Trust		
Trustee Information		
Charitable Trust Account		
Charitable Donation Preferences		

NOTES:

Investment Documents	Provider Contact Information	Location of Documents
Brokerage Account Statements		
Mutual Fund Account Statements		
Other Managed Account Statements		
Stock Certifications Not Held in an Account		
Bearer Bonds not Held in an Account		
Alternative Investments (including K-1s)		
529 College Savings Plan Statements		
Cost Basis Papers		
Online Transaction Confirmation		
Concentrated Stocks (10b5-1 Selling Plans, Rule 144/145 Sales & Lending		

Retirement Documents	Provider Contact Information	Location of Documents
IRA Statements		
Company Retirement Plans Statements from all Employees, e.g. 401(k), 403(b)		
Other Company Benefits (stock options deferred compensation)		
Deferred Compensation Agreement		
Beneficiary Forms for IRAs, 401(k) or Other Benefit Plans		
Variable or Fixed Annuities Statements		
Beneficiary Forms for Annuities Policies		

Credit and Lending Documents	Provider Contact Information	Location of Documents
Mortgage		
Home Equity Line Papers		
Loan Management Account Statements		
Securities-Based Loan		
Car Loan		
Other Outstanding Loans		
Promissory Notes		
Rental and/or Lease Agreements		

Credit Cards	Number	Contact Information

Business Documents	Provider Contact Information	Location of Documents
Incorporation/Ownership Papers		
Financing Papers		
Payroll Records		
Employee Records		
Employee Retirement plans		
Stock Option Plans		
Other Employee Benefit Plans		
Credit Card Statements		
Buy/Sell or Partnership Agreements		

Inventory and Appraisal of Valuable Personal Property

Inventory Type	Location	Insured Yes	Insured No	Date of Purchase	Purchase Price Value

ESTATE PLANNING ISSUES AND UPDATES

CHAPTER 7 SUGGESTED GIFTING STRATEGIES

a. With the value of many assets low, this presents an opportunity for wealthy individuals to transfer assets at no current gift tax cost by using the annual exclusion amount and lifetime gift tax exemption.

b. Business owners who want to transfer an interest in their companies to children or other family members can maximize the use of the annual exclusion and lifetime exemption by taking valuation discounts into effect. Additionally, sales opportunities should be explored in this economic climate.

c. Because of reduced values, simple gifting strategies may replace more complex ones that were necessary with larger value gifts. The more complicated strategies often involve a significant degree of administration that is a burden to some clients.

PLANNING IN THE "PERFECT STORM" – LOW VALUES, LOW INTEREST RATES, CHANGE ON THE WAY

A. Loans to Family Members

a. Low interest loans can transfer significant value to family members without constituting a gift for gift tax purposes. Clients can lend money to a child at rates well below bank rates.

b. A client can make a low interest loan to a child but forgive part of that loan each year through the annual gift-tax exclusion (currently $13,000 per donor/per done).

c. Parents may use family loans to help children buy a home. The parents could also reduce the loan each year by making annual gifts to the child to lower the principal.

d. It would also be a good idea to consider refinancing existing intra- family loans which were created at higher interest rates. It is important that these loan modifications be drafted carefully to avoid gift tax consequences to the creditor. First, determine whether the original loan documents restrict or penalize the borrower for prepayment. Any such terms must be carefully adhered to. Some practitioners believe that a modification should be accompanied by other changes

that could provide a legal "consideration" for the modification. For example, if the remaining term on the loan being modified was 20 years, the replacement modified loan could be for 18 years, etc.

i. Every loan should be properly documented with appropriate written legal documents.

B. <u>Consider a Variety of Estate Freezing Transactions</u>

<u>Grantor Retained Annuity Trust (GRAT) – Private Split Interest Trust</u>

a. Can benefit from current low interest rates.

b. A GRAT enables a person to effectively "freeze" current values of assets held in trust for estate tax purposes. The grantor receives an annuity for a fixed term of years (usually less than 10 years) and calculates gift tax, if any, on the present value of the remainder interest in the trust using IRS-set interest rates. At the end of the term, the named beneficiary (usually the grantor's child) recovers the assets in the trust with no additional transfer cost.

c. Under current law it is possible to set up a GRAT that will result in no taxable gift or a nominal one.

d. This technique is very popular with clients who have a family business or depressed stock expected to increase in the future. It helps pass on most of the increased value tax free to the heirs.

e. Watch compensation and other related party payments on family business interests that are given to GRATs to avoid a risk of an indirect additional contribution which is forbidden.

f. If discounts are legislatively restricted, future GRATs on non-discountable assets may not be viable.

g. The Green book issued by the Obama administration has proposed a 10 year minimum term on GRATs which was recently passed by the House. Clients pursuing the

common strategy of short term rolling GRATs should consider that the "roll" soon may not be available.

Qualified Personal Residence Trust ("QPRT")

a. Reduced property values also favor the use of Qualified Personal Residence Trusts (QPRT's) – another planning vehicle that reduces the transfer tax cost related to a residence. This benefit for the QPRT technique may be offset by the low interest rate environment which has the opposite effect. Make "what if" projections to determine if the QPRT is really viable.

b. A parent transfers a residence, while values are low, to a child using a QPRT. For gift tax purposes, the gift is the present value of the future interest in a home (after subtracting the parent's retained term, usually 10 years or so). At the end of the term, the child obtains full ownership of the home with no further transfer taxes.

c. The parent can remain in the home by paying rent to the child (which effectively produces more estate tax savings for the parent by removing the funds for rent from the parent's estate with no transfer tax cost).

Installment Sales

The installment sale is a particularly effective tool for estate planning especially with intrafamily transactions. However, care must be taken as there are traps for the unwary. Installment sales are especially useful in the current low interest rate environment. Particularly in the intrafamily situation, it is attractive for clients who would like to sell assets or a business to the younger generation on very favorable terms. The terms of the installment note can be more flexible than conventional financing.

Advantages of the Installment Sale:

a. Spreads the gain on the sale over the term of the note resulting in deferral.
b. Removes future appreciation of property from seller's estate.
c. Removes the income from the asset out of the seller's estate.

d. The sale provides cash flow to the seller.
e. The sale allows restructuring of estate assets to qualify for tax benefits such as IRC Secs. 303, 2032A, etc.

IRC Sec. 267 Related Party Rules

The related party rules are a "trap for the unwary" and must be thoroughly understood. IRC For instance, IRC Sec. 267 disallows the recognition of loss on sales or exchanges between related parties. This provision in the Tax Code was created to prevent taxpayers from manipulating the recognition of losses or creating losses where no actual economic loss has been realized. This disallowance provision is broad based and applies to all transactions even those where the sale is bona fide and the terms are negotiated at arms-length. The rules even apply to involuntary sales and, of course, the disallowance does not apply to gains.

Related parties include family members such as brother, sisters, spouses, ancestors and lineal descendants. But they also include the following:

(i) An estate and beneficiary of the estate;
(ii) A grantor and a fiduciary of a trust;
(iii) A fiduciary of a trust and a beneficiary of the trust;
(iv) A fiduciary of a trust and a fiduciary of another trust is the same person is grantor of both trusts.
(v) A fiduciary of a trust and a beneficiary of another trust if the same person is grantor of both trusts; or
(vi) A corporation and the fiduciary of a trust if more than 50% of the corporation's stock is owned, directly or indirectly, by the trust or grantor of the trust.

A disallowed loss, however, may reduce the related buyer's gain on a subsequent sale under IRC Sec. 267(d). If the subsequent sale results in a loss, the loss on the first sale is lost forever.

IRC Sec. 1239 Rules

IRC Sec. 1239 requires that where property is sold between related parties and the property is depreciable by the buyer, any gain on the sale is treated as ordinary income to the

seller. If the property is both depreciable and nondepreciable, it is necessary to allocate the gain between the depreciable and nondepreciable property. Related parties are also broadly defined under IRC Sec. 1239 and include a taxpayer and any controlled partnership or corporation, any trust in which the taxpayer or the taxpayer's spouse is a beneficiary, and an estate and beneficiaries of the estate. IRC Sec. 1239 does not apply in the estate situation where property is distributed in satisfaction of a pecuniary bequest [IRC Sec. 1239(b)(3)].

IRC Sec. 453(g)

If depreciable property is sold between related parties, the sale is not eligible for installment treatment under IRC Sec. 453(g). The entire amount is deemed received in the year of sale. There is an exception under Sec. 453(g)(2) if the taxpayer can demonstrate that the principal purpose of the transaction is not the avoidance of tax. When the sale involves both depreciable and nondepreciable property, the gain may be allocated between the two types of property.

Like Kind Exchanges & Related Parties

If property is exchanged to a related party and the purchaser disposes of property within 2 years, gain or loss is recognized on the original transaction and Sec. 1031 does not apply. However, the gain is recognized in the year of the subsequent sale and not the original sale.

Important exceptions to this rule include:

(i) Death of either party;
(ii) Where the sale is compulsory or involuntary; and
(iii) Where there is proof that there was no avoidance of tax.

Disposition of Installment Note at Death

An installment note is considered property and is subject to inclusion in the estate of the owner at death. The person succeeding to the installment note recognizes income as collected using the same terms as the decedent during his or her lifetime. The transfer by gift of a pre-death installment note is usually not a disposition of an installment obligation that would trigger an acceleration of gain recognition under IRC Sec. 453B(c).

Installment Note as IRD

An installment owned by a decedent at death is considered Income in Respect of a Decedent (IRD) under IRC Sec. 691. It is:

(i) Included in the estate for estate tax purposes;

(ii) Does not receive basis adjustment under IRC Sec. 1014/1022;

(iii) The unrecognized gain (excess of face over its basis) is considered Income in Respect of a Decedent (IRD) possibly resulting in both income tax and estate tax [IRC Sec. 691(a)(5)];

(iv) While the note may be discounted for estate tax purposes, the fair market value is deemed its face amount where the buyer and seller are related;

(v) The estate tax deduction is available if the asset generated estate tax; and

(vi) A pecuniary bequest satisfied with an installment note is treated as a sale or exchange and deferred gain is triggered and accelerated.

Note: If the installment note is cancelled at death, the gain remaining on note is triggered. Also a post-death installment note distributed to a beneficiary will accelerate the gain.

THE INSTALLMENT SALE TO AN ITENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

Instead of gifting assets to the IDGT, the grantor could sell them to the IDGT on the installment method using the low interest rates, favorable terms and lower values available in today's market. An installment sale to an IDGT does not use the Sec. 7520 interest rate, but regular AFR interest rates which are generally lower.

As we know, through careful drafting, an IDGT is an irrevocable trust for transfer tax purposes and a grantor trust for income tax purposes. This can be done because while most of the transfer and income tax rules run parallel, there are some administrative powers in the income tax area that make a trust a grantor trust (taxable to the grantor) for income tax purposes but the assets in the trust are not includible in the grantor's estate for estate tax purposes (irrevocable).

Benefits of a Grantor Trust

a. Can hold S corporation stock.

b. Grantor trust can benefit from deductions and exclusion only available to natural persons.

c. Grantor trust can accumulate or distribute amounts free of tax.

d. Grantor's payment of tax further reduces the grantor's estate.

e. Transactions between the grantor and the trust are ignored for income tax purposes.

f. Power to substitute is usually used and very powerful to control adjusted basis issues. Also the power to add charitable beneficiaries is often used as well.

g. The income tax rates for the grantor are more favorable than the compressed income tax rate structure currently in effect for trusts and estates.

Example:

John Jones creates an irrevocable trust with his children and more remote descendents as beneficiaries. He gifts seed money to the trust using his annual and lifetime gift tax exclusion amount. He allocates GST exemption to the trust. He then sells $5,000,000 of S Corporation stock to the trust taking back an installment note. The independent trustee has discretion to make distributions of income and principal to the beneficiaries. At John's death, the remaining trust principal is divided into equal shares and distributed in trust to each living child or each deceased child with living issue. The trust has been drafted with provisions that make it a grantor trust for income tax purposes and an irrevocable trust for transfer tax purposes.

Benefits of Sales Transaction to IDGT

a. The grantor does not recognize any capital gain of the sale of the assets to the grantor trust.

b. The retention of powers resulting in grantor status does not trigger estate tax recognition.

c. If the yield of the transferred assets exceeds the interest rate of the note, SCIN or private annuity, then the sale of assets to the IDGT produces significant tax savings.

d. IRC Sec. 671 imposes upon the grantor the legal obligation to pay tax on any income from the trust.

e. The assets accumulate in the trust without the imposition of federal income taxes.

f. Valuation discounts allow the grantor the opportunity to leverage wealth transfers, shifting more value to heirs in trust for less tax cost.

g. Grantors may shift appreciation in value of the trust assets through the power of substitution.

h. The grantor may immediately allocate part or all of his or her GST exemption to any gift element in the trust.

i. The grantor avoids gift tax if the FMV of the transferred property equals the value of the note or annuity.

j. There are asset protection features available.

Because all transactions between the grantor and the trust are ignored, there will be no capital gain on the transactions and the interest paid on the note is not taxed to the grantor. The revenue stream to the grantor may be very helpful during the grantor's retirement years. If the grantor dies before the note is paid off, only the remaining balance on the note will be included in the grantor's estate.

It is best, if possible, to pay off the note while the grantor is alive because of uncertainty. The adjusted basis of the grantor carries over to the trust for income tax purposes. Rev. Rul. 2004-64 indicated that the trustee's discretion to reimburse the grantor for the payment of taxes (whether exercised or not) will not cause the trust's assets to be included in the grantor's gross estate under IRC Sec. 2036(a)(1). Also Rev. Rul. 2008-22 holds that the grantor's power to substitute does not cause assets of the trust to be included in the grantor's estate under IRC Sec. 2036 or 2038. The Ruling states that this result is reached so long as the trustee has a fiduciary obligation (either under local law or the terms of the governing instrument) to ensure that the properties acquired and substituted by the grantor are, in fact, of equivalent value, and so long as the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

Variations on Sales Transaction Involving an IDGT

a. SCIN Sale to IDGT

b. Private Annuity Sale to IDGT

c. Gift of IDGT Installment Note to Charity

a. Replace the Installment Sale with a Self Canceling Installment Note (SCIN)

SCIN Review

A self-canceling installment note (SCIN) is an obligation that results from an installment sale where the terms include a provision that, upon the death of the transferor or seller of the property, all future amounts due are canceled. The transaction is also known as a self-canceling installment sale (SCIS). Any outstanding obligation which is canceled at the seller's death is not included in the seller's gross estate. The value of the balance due on the SCIN at the seller's death escapes federal estate tax.

If the seller's life expectancy is shorter than what might be expected for an individual his or her age, consideration should be given to this strategy. Also, in an environment of lower interest rates and uncertain market values, SCINs become an attractive estate planning tool. SCINs can charge a lower interest rate with lower payments for the payors (usually lower-generation family members) than conventional installment sales to third parties.

If the transaction is set up properly, none of the value of the transferred property will be included in the estate of the transferor at death. This is because the transferor possesses only the right to receive payments for the rest of his or her life. Since the incidents of ownership end at death, nothing remains to include in his estate.

However, if the underlying property is sold within two years of the transaction, the seller will recognize all of the deferred gain in the year of that sale.

Elements to Include in a SCIN:

a. The death-extinguishing provisions should be included in the sales agreement as well as the installment note.

b. In every case, the note must be in connection with a bona fide sale for full and adequate consideration that includes a risk premium for the terminating provision as part of the

bargain. In determining the risk premium to add to the consideration, many factors may be considered, including the size of the down payment, the term of the note, and the life expectancy of the transferor. The parties to the transaction should take into account the seller's actual survival prospects, including a consideration as to whether his or her health is above or below average.

c. The transferor must have no power to revoke the cancellation provision.

d. The transferor should avoid retaining extensive control over the transferred property.

e. To avoid imputed interest, the transaction should provide for a fair interest rate that meets the requirements of IRC Sec. 483.

f. The term of the note should be no longer than the actuarial life expectancy of the transferor. The Service indicated in GCM 39503 that it would treat a transaction with a longer term of payments as a private annuity.

The Income Tax Issues in a SCIN

Debate had continued for years with regard to the SCIN and whether deferred gain was recognized for income tax purposes when the self-cancellation feature becomes operative (at the death of the transferor). Additionally, it was debated where to recognize the gain on the decedent's final income tax return or on the first income tax return of the estate? Rev. Rul. 86-72 and *Estate of Frane*, 998 F.2d 572 (8th Cir. 1993) settled some of these questions. In the *Frane* case, the decedent sold appreciated property to members of his family in exchange for SCINs. The lower court held that the cancellation of the SCINs at the decedent's death caused gain to be recognized on the decedent's final income tax return. The appellate court reversed the Tax Court decision and concluded that the income is taxable to the estate under IRC Sec. 691(a)(2), which is less favorable than the Tax Court's reversed decision. This is because estates are exposed to more compressed tax rates than those of individuals and the tax liability is generally higher. Additionally, reporting the income on the final return would afford an estate tax deduction for claims against the estate, the decedent could offset the gain with losses that could possibly go unused. Thus, in any case, where a SCIN arrangement is contemplated for transferring greatly appreciated property, the income tax consequences that would result from the untimely death of the transferor should be seriously considered. Reduced values and the use of valuation discounts can lessen the gain recognized on the transaction.

Using a SCIN Sale to an IDGT

Because a SCIN is an installment note with a self-canceling feature, its use should be contemplated in combination with an IDGT. The grantor would sell assets to the IDGT and take back a SCIN. Any outstanding obligation at the grantor's death is cancelled and not included in the gross estate. Additionally, the IRS treats the grantor as owning the trust and all of its attributes, including item of income, deductions, and credits, for federal income tax purposes. Therefore, any gain recognized on the initial transactions and all payments of both principal and income are not taxed. The income earned from the assets in the IDGT is taxed to the grantor.

Replace the Installment Note with a Private Annuity Sale to an IDGT

The private annuity is a tool that can be used very effectively in estate planning if its use is fully understood. This strategy can be very valuable in a family transfer situation when typically an older-generation family member transfers an appreciating asset to a younger-generation family member in trust in exchange for the transferee's promise to make fixed, periodic payments for the remainder of the transferor's life. The transferor receives a steady cash flow stream and the property can be retained within the family unit. The transferor is relieved of the burdens associated with the ownership and management of the property as will his or her estate. Its potential use includes:

a. Excluding assets from the taxable estate;
b. Freezing the value of estate assets;
c. Paying children's income tax as a tax-free gift;
d. Achieving creditor protection; and
e. Transferring real property without reassessment of property taxes.

Private Annuity Review

An annuity is a contractual relationship in which the party that receives the assets ("Obligor") promises to pay to the party who transfers the assets ("Annuitant" or "Transferor") a fixed sum payable either monthly, quarterly, or annually, for the duration of the transferor's life as consideration for the property transferred. Often an annuity is purchased from an insurance company. A private annuity is where no insurance company is involved. Rather, the "Obligor"

is a family member or members or a family trust. Traditionally, the payment to the annuitant under a private annuity contract must be unsecured.

Exclusion from Estate Taxes

Generally, when a decedent dies, the value of an annuity in which payments were being received by a decedent at the date-of-death is included in the gross estate under IRC Sec. 2039. However if all rights to receive payments terminate upon the annuitant's death, no "transfer at death" takes place. At the death of the "Annuitant," the private annuity terminates and no further payments are received. Because of this termination at death provision, nothing is included in the estate of the client. IRC Sec. 2033 provides for the inclusion in the gross estate of property rights that the decedent owned at the time of death. If no rights exist, then no inclusion is necessary. If, however, the transferor retains an interest in the property transferred that was not the subject of a bona fide sale for a full and adequate consideration, Section 2036 will require inclusion in the annuitant's gross estate. Examples of retained interests that would trigger Section 2036 include:

a. The annual private annuity payments equal the annual income of the property transferred;
b. The source of annual private annuity payments comes solely from the property transferred;
c. The transferred property serves as security for future payments to be made by the transferee;
d. The transferor maintains voting rights in the securities transferred, or has the right to veto the sale of the transferred property.

Gift Tax Considerations

If the fair market value of the transferred property exceeds the present value of the annuity payments, such excess is a taxable gift for gift tax purposes. All normal gift tax rules apply and therefore, up to $13,000 (indexed for inflation) of the excess can be sheltered from gift tax by the transferor's annual gift exclusion. In order to avoid a taxable gift, the annuity payments should be set so that the present value of the payments, based on the life expectancy of the transferor, equals the fair market value of the property. If the buyer has difficulty meeting

the payment obligations, the seller can use his annual gift tax exclusion to forgive up to $13,000 per year of annuity payments, although it is important to be able to demonstrate that a bona fide debtor-creditor relationship exists.

The present value of the gift is determined by the present value tables in Treasury Reg. 25.2512-9(f), not the annuity tables in Treasury Reg. 1.72-9. However, the annuity tables in this section are used for the income tax computation.

Income Tax Considerations

Pre October 18, 2006

Under rules enacted prior to October 18, 2006, the transfer of property in exchange for an annuity typically generated a gain that was recognized ratably as the annuity payments were received over the transferor's life (Rev. Rul. 69-74). The overall gain to be recognized was determined by subtracting the transferor's basis in the property from the present value of the annuity, which is to be determined by using IRS actuarial tables (IRC Sec. 7520). The overall gain was reported ratably on a straight-line basis over the transferor's life expectancy as of the annuity starting date.

If the property transferred was a capital asset, the gain was a capital gain. If the private annuity sale involved related parties, no loss will be recognized on the initial transfer because of the related party loss limitation rules of IRC Sec. 267. In addition to the capital gain component, each annuity payment included an interest, or ordinary income component, to the extent the annuity payment exceeded the sum of the gain component and the return of investment or basis component. Rev. Rul. 69-74 requires that from each payment received, the return of investment (basis) portion and the capital gain portion are subtracted, and the remaining amount is ordinary income. While this ordinary income portion is similar to interest, it cannot be deducted by the payor of the annuity. However, the ordinary income portion is included in the calculation of the buyer's adjusted basis in the property.

Post October 18, 2006

Prop. Regs. 172-6 and 1.1001-1 issued and effective Oct. 18, 2006 dramatically changed the income tax treatment of an exchange of property for a private annuity contract in an attempt to correct perceived abuses in the private annuity area. Now if an annuity contract is received in

exchange for property other than money, the amount realized attributable to the annuity contract is its FMV determined under the Sec. 7520 rules in effect a the time of the exchange. Additionally, the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of what method of accounting the taxpayer uses. To determine the initial investment in the annuity contract under IRC Sec. 72(c)(1), which is the amount that determines the taxation of future payments from the annuity contract, the total amount of premiums or other consideration paid for the annuity contract equals the fair market value of the annuity contract. Therefore, any gain in the property exchanged under an annuity contract would be taxable at the time of sale rather than being amortized over the period of the annuity contract. These regulations treat private and commercial annuities the same.

Adjusted Basis

The transferee's basis in the property is generally the present value of the annuity. This is the amount used to determine the seller's gain. But if the transferor dies prematurely, the transferee's basis is limited to the annuity payments actually made. However, if the transferor outlives his actuarial life expectancy, the transferee's basis is increased by the additional payments made. In this situation, the cancellation of a private annuity at death would not result in IRD to the transferor's estate. This is an important difference from the SCIN.

Downside to Annuity Strategy

The downside to the annuity strategy is that the annuitant could outlive his or her actuarial life expectancy which could cause the buyer (obligor) to pay more for an asset than he or she otherwise would. Also the IRC Sec. 1014/1022 step up basis adjustment is unavailable upon the transferor's death. Additionally it is difficult to determine the income tax basis of the transferred assets and the interest component on the annuity payment is nondeductible to the payor.

In order to successfully achieve all the goals stated above, often a trust is combined with the private annuity. The transferor may want to consider obtaining life insurance and/or disability on the transferee. However, the insurance should not be tied to the private annuity in any way.

Case Law and the Private Annuity

Traditionally, use of a private annuity for estate planning purposes has been considered high risk because the Internal Revenue Service has announced a specific dislike of the strategy. The courts have taken a different view and especially the Court of Appeals for the Ninth Circuit has upheld the use of the private annuity as a proper estate planning vehicle if it follows the IRS guidelines. This is evident in *Sidney B. Stern v. Commissioner* ,77 T.C 614 (1985). In this case, the Ninth U.S. Circuit Court of Appeals approved a controversial arrangement that allowed a couple to void more than $2.5 million in taxes by transferring stock of their closely held businesses to an offshore trust in the Cayman Islands in exchange for a lifetime annuity. Importantly, the Court held that such a transfer of property into trust in exchange for a lifetime annuity could not be recharacterized by the IRS as a transfer with a retained interest (IRC Sec. 2036).

The holding in *Stern* follows a previous appellate court decision in *E. La Fargue* in which the appellate court also reversed a Tax Court recharacterization of an annuity transaction as a transfer to trust with a retention of income. The court in *La Fargue* held that a transaction will be characterized as a sale in exchange for an annuity if the taxpayer follows certain formalities and the annuity is not tied to trust income.

Weidl v Commissioner is informative as the case lists several factors used to determine whether the transaction takes the form of a sale of property to a trust in exchange for an annuity or a transfer in trust by a grantor/beneficiary. These factors include the following:

1. The relationship between the creation of the trust and the transfer of property to the trust;
2. The relations between the income generated by the transferred property and the amount of the annuity payments;
3. The degree of control over the transferred property exercisable by the annuitant;
4. The nature and extent of the annuitant's continuing interest in the transferred properties;
5. The source of the annuity payment; and
6. The arms length nature of the annuity/sale arrangement.

Noticeably absent from this list is the deferral of income taxes. At all time, the cost of income taxes must be considered in order to make the strategy work. The payor of an annuity cannot deduct the payment to the annuitant as is possible in the SCIN situation. Therefore the after-tax cost of the payment must be considered. Additionally, payments to the annuitant are taxable.

Adequate Capitalization of Obligor

An essential ingredient of a successful private annuity transaction is an obligor who is adequately capitalized. In PLR 8030074, the IRS discussed the tax consequences of exchange of stock for a joint and survivor annuity. The owner of stock in a corporation, intending to retire, planned to transfer stock ownership in his corporation to his two children in exchange for an unsecured annuity during his lifetime. When he died, the annuity would continue for the benefit of his wife for her life. The proposed transaction would be deemed a gift to the children to the extent that the value of the transferred property (the stock) exceeded the present value of the joint and survivor annuity. The IRS also provided the factor to be used in determining the present value of the annuity.

Private Annuity Sale to IDGT

To ameliorate the rather severe consequences of the immediate recognition of capital gains on the use of a private annuity to purchase assets from the grantor, an IDGT can be used. Because of the nonrecognition treatment, there would be no gain on the initial transaction nor any gain throughout the annuity term. Additionally if the transferor had a life expectancy shorter than what would be expected for his or her age, this strategy should be considered.

In this transaction, the annuity is always unsecured and the IDGT is seed with at least 10% to provide equity to the trust. The IDGT does not pose the same potential for abuse as the private annuity trust that prompted the 2006 proposed regulations. Because the property sold for the annuity does not receive a step up in basis on the transfer to the IDGT, if the property is subsequently sold, there would be gain on the transaction. If the seller dies in a shorter time than predicted by the tables, payments stop and no more are due. As a result, the transferor's estate is reduced without transfer tax consequences.

This strategy follows the same tax consequences as the installment sale to and IDGT and under Rev. Rul. 85-13, 1985-1, the sale results in no recognition of gain or loss. The seller is taxed on all income of the IDGT and the IDGT's annuity payments are not separately taxable to the seller. Additionally, the annuity payments are not deductible by the IDGT and have no effect on the IDGT's income tax basis in the purchased assets.

The Exhaustion Test

The provisions of Treas. Reg. Sec. 25.7520-3(b)(2)(i) must be considered when a private annuity is considered. This Regulation requires a reduction in the value of the annuity when the annuity can be considered to exhaust before the final payment is made. It is assumed under this section that the transferor will live to be 110 years old. See Example 5 of Treas. Reg. 25.7520-3(b)(2)(v). In this example a donor who is 60 years old transfers property worth $1,000,000 to a trust which is to make annual payments of $100,000 to a charitable organization for the life of the donor. At the time this example was written, the Sec. 7520 interest rate was 6.8%. The Example concluded that the trust would only be able to make 17 annual payments in full and would be exhausted after making a final 18th partial payment. Therefore, to determine the distribution to the charity, the payments to the charity would be recharacterized as a distribution to the charity for the shorter of the donor's life or 17+ years. The Example then concluded that of the $1,000,000 originally placed in trust, only $880,213.38 qualified for the charitable deduction and the resulting $119,786.62 resulted in a taxable gift.

To get around the gift tax issue, additional assets must be made available to the IDGT to cover the possibility that annuity payments might be required to be made until the transferor reaches the age of 110. This is in addition to seed money. Such a transfer would involve a gift by the transferor which may be unacceptable because of gift tax consequences. Therefore, a guarantee by an unrelated party in exchange for a fee should be considered to avoid the gift tax consequences as a transaction in the ordinary course of business.

If the transferor dies prior to the time predicted under the actuarial tables, the cost of the guarantee or the gift tax could be well worth it.

Gifting the Installment Note from the IDGT to Charity

If the client has charitable objectives and would like to gift assets to charity but wants to maintain the business assets for the children, one solution would be to create an IDGT and sell the business assets to the IDGT that are intended for the children. The grantor would take back an installment note as previously described above. The grantor would then gift the installment note to a qualified charity and would receive an income tax deduction in the year of the gift. As the profits to the business are distributed to the IDGT, these funds would then be used to pay the installment note but as the charitable organization holds the note, the funds would be paid to the charity. This strategy is especially effective when the charity is a private foundation or where the exempt income tax rules prevent the charity from holding a business interest. As the note is paid off, the IDGT, whose beneficiaries are the children own a larger and larger equity interest in the business. The stock or units purchased by the IDGT are out of the grantor's estate and everybody wins.

ADDING A CHARITABLE COMPONENT TO THE ESTATE PLAN

Several studies have indicated that the recent economic uncertainty has caused a decrease in charitable giving. However, if the marginal tax rate on ordinary income and capital gains does increase to 39.6% and 20% respectively in 2011, the charitable contribution deduction will be worth more in offsetting these higher taxes. The reinstatement of the 3% phase-out of itemized deductions for taxpayers with higher adjusted gross income must also be taken into consideration. Regardless, it is a good time to consider charitable strategies that not only have transfer tax benefits but income tax benefits as well. Because of the low interest rate environment, some charitable strategies work better than others.

Income Tax Deduction on Gift of Remainder Interest in Personal Residence

IRC Sec. 170(f)(3)(B)(i)) provides an exception to the general rule of IRC Sec. 170(f)(3) that disallows a charitable contribution income tax deduction for a gift of a partial interest in property that is not in a qualified trust. IRC Sec. 170(f)(3)(B)(i)) provides an income tax deduction for a charitable contribution not in trust of an irrevocable remainder interest in a personal residence or farm that is not the donor's entire interest in the property.

A personal residence includes any property used by a taxpayer as a personal residence and is not limited to the taxpayer's principal residence. [Reg. Sec. 1.170A-7(b)(3).] Rev. Rul. 75-420, 1975-2 C.B. 78 specifically addressed this issue and indicated that a gift of a remainder interest in a vacation property constituted a deductible gift of a remainder interest in a personal residence. See Reg. 20.2055-2(e)(2)(ii) & (iii) for farms. It includes the residence but not the furnishings. (Rev. Rul 76-165).

If a life interest in the residence is gifted to a non-charitable beneficiary and the remainder to charity, a co-tenancy has been created and the gift of the remainder interest to charity is available for a charitable deduction but a valuation discount must be applied (Rev. Rul. 87-37, GCM 39628).

Income Tax Deduction

Where the property consists of both land and improvements, consideration is given to the fact that the improvements will depreciation over the passage of time and become less valuable than at the time of the gift. To calculate the income tax deduction, straight-line depreciation is to be taken into account in valuing a remainder interest in the improvement on real property and the value is to be discounted at the rate set forth in the estate and gift tax regulations. For estates of decedents dying and gift made after April 30, 1989, the Sec. 7520 discount rates are used. See Reg. 1.170A-7(c).

The present value of the remainder interest in the personal residence is stated at both a dollar amount and a percentage of the total value of the property. These values incorporate the valuation principals of IRC Sec. 170(f)(4), Sec. 7520 interest rates and mortality tables currently in existence. Also the gift of the remainder interest in the vacation home qualifies for a current charitable contribution income tax deduction subject to 30% of donor's modified gross income with a five-year carry over period.

The Estate Tax Consequences on the Death of the Grantor/Second Spouse

It is well settled that where a person transfers property but reserves the right to use that property for life, the full value of the property will be included in the estate of the grantor/life tenant on death under the provisions of IRC Sec. 2036(a). The purpose of inclusion of the full value of the assets into the taxpayer's estate under the provisions of IRC Sec. 2036(a) is to

prevent taxpayers from retaining the practical benefits of asset ownership during their lifetime while divesting themselves for estate tax purposes of a portion of that property. However, that is the exact articulated purpose of a donor gifting a remainder interest in a personal residence outright to charity.

At the death of the grantor or surviving spouse, the entire value of the vacation home will be included on the grantor's or surviving spouse's gross estate on Form 706 with a corresponding estate charitable contributions deduction. IRC Sec. 2055(a) provides, in part, that in determining the taxable estate of a decedent, there shall be deducted from the value of the gross estate the amount of all bequests, legacies, or transfers to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes.

However, IRC Sec. 2055(e)(2) further provides that where a remainder interest in property passes or has passed from the decedent to a person, or for a use, described in Sec. 2055(a), no deduction shall be allowed in the case of a remainder interest unless such interest is in a trust which is a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund. An exception to this general rule of nondeductibility is an interest as described in IRC Sec. 170(f)(3)(B) above. A distinct exception to the limitation on estate tax charitable deductions for transfers of partial interests other than in specifically described charitable trusts is made for charitable gifts of remainder interests in a personal residence or farm. Its qualification for the estate tax charitable deduction is further described under Reg. 20.2055-2(e)(2)(ii).

The disallowance rules under IRC Sec. 2055(e) were created by Congress in 1969 to curb perceived abuses in deductions taken for charitable remainder interests where there was little relationship between the interest assumptions that created the deduction and the amount actually and eventually received by the charity. The thrust of the legislation under IRC Sec. 2055(e) allowed deductions only for those charitable remainders left in a manner which would provide adequate assurance that the remainder interest would be realized by the charity. The outright gift to charity of the remainder interest in a residence or farm guarantees the charity the eventual deed upon the termination of the life estate while a remainder interest that passes in trust that is not a charitable remainder or lead trust would be subject to the trustee's exercise of discretionary

powers that could significantly dilute the amount realized by the charity. The disallowance provisions sought to curb this type of abuse.

Additionally, on the death of the first spousal donor, the transfer will qualify for the unlimited marital deduction provided that both spouses are the sole noncharitable tenants [IRC Secs. 2056(b)(7) and 2523(f)].

It may be contemplated that the charity will not retain the remainder interest for the entire term of the retained life tenancy. The fact that the remainder interest may be disposed of by the charity and sold at its fair market value to an independent party should not defeat the charitable deduction. While there is no case law directly on point supporting this, the charitable deduction for the remainder interest fits both within the spirit and the letter of the law. Provided the charity and the purchaser are unrelated and there is no prearranged obligation to participate in the transaction, the remainder should be considered as purchased for full and adequate consideration.

There are a series of rulings by the Service that discuss the availability of the charitable estate deduction when sales of the property are contemplated in the governing instrument. Previously, the IRS had taken the position that proceeds from the sale of the residence where the remainder was gifted to charity did not qualify for the estate tax charitable deduction. In Rev. Rul. 77-169, the IRS disallowed a charitable deduction for a bequest of a remainder interest in a decedent's personal residence to a charity under a will which provided that the property was to be sold upon the life tenant's death with the entire sales proceeds paid to charity. However, in *Blackford Est. v Comr.,* 77 T.C 1246 (1981), acq., 1983-2 C.B.1, the court allowed a charitable deduction for the present value of the remainder interest in a personal residence under IRC Sec. 2055(a) even though the decedent's will directed the executor to sell the property when the life tenant died and distribute the proceed to several named charities. In the court's view, the potential for abuse through diminution in the value ultimately received by the charity, which IRC Sec. 2055(e) was designed to address, did not arise where the estate bore the expense of selling the residence. The remaindermen could institute an action against the executor for failure to preserve their interests, and under state law could elect to receive the property in kind. The Court even stated at page 1251, footnote 4 that the charities, several fire companies would have little practical use for a one-fourth interest in a personal residence and could be expected to sell such interest as soon as possible. Based on the findings in this case, Rev. Rul. 83-158 held that a charitable deduction is allowable for the value of the charitable remainder interest in proceeds

from the sale of a decedent's personal residence if, under local law, the charity has the option to take the residence instead of the sales proceeds. Rev. Rul. 77-305 indicated that the donor cannot require as a condition of the initial gift that the charity agree to a sale of the property if the life tenant ever wants to sell. Other rulings have held that a charitable deduction will be disallowed where the life tenant has an unfettered right to sell the property without consent from the charity.

Therefore, based on these rulings by the Service, the estate tax charitable deduction should continue to be available at the death of the surviving donor.

The Adjusted Basis of the Residence at Various Points in the Strategy

Because the strategy extends over a period of years and may be subject to transfers and changes, it is necessary to determine the adjusted basis of the residence in regard to differing scenarios.

At the time of the initial gift of the remainder interest to the charity, the adjusted basis of the residence would be that of the donors. In the event that the property is sold before the death of the second spouse, any gain or loss to the donors would be calculated based on their pro rata share of the cost basis of the property (Rev. Rul. 84-43, 1984-1 C.B.27). The basis to the parties is determined at the time the transaction is entered into and percentages are assigned to the current and remainder parties. At the time the property is sold, the actual percentages of ownership could change as the donors are now older and the life estate has decreased with a corresponding increase to the remainderman. However, even though the value of the life estate decreases with the passage of time, IRC Secs. 1015 and 1016 indicate that the basis in the hands of the life tenants and the remainderman is fixed at the time of the gift unless subsequently changed by further investment or improvements to the property. PLR 8529014 held that if the donor improves the property after donating the remainder interest at the donor's expense, an additional charitable deduction for the remainder interest in the improvement is allowable provided that the improvement legally becomes part of the real estate.

If the remainder is sold by the charity to a third party and then the entire property is sold, the adjusted basis would be a combination of the basis allocated to the life tenant and the purchase price paid for the remainder interest by the third party.

The Necessary Components of the Life Estate Agreement

A life estate agreement essentially spells out the responsibilities of the life tenant during the term of the life estate. It is well settled that the life tenant is responsible for the payment of real property taxes, reasonable maintenance, insurance expenses and repairs as well as the interest on any outstanding mortgage on the property. If the life tenant fails to make these payments and the remainderman makes them in order to protect its interest in the property, the remainderman would have a lien against the life tenant's interest. Of course the grant language in the life estate agreement could provide other responsibilities agreed to by the parties.

Additionally the agreement should anticipate the possibility of the life tenant vacating the premises and the rental of the property to third parties. The life estate agreement can also provide for the sale of the property and even repurchase of a replacement property with a continuation of the retained estate or a division of the sales proceeds. The charity may want to contemplate adding the real property to their master property insurance policy in the event the property incurs damage that is not covered by the donors' policy.

Property Tax Issues

Because property tax assessment is a function of state and local laws, it will be important to analyze the property tax issues in relation to where the personal residence is located. The general rule is that because the life tenant has retained a full possessory interest in the residence, no change of ownership should occur that would result in a reassessment of taxes.

Conclusion

The gift of a remainder interest in a residence or farm to charity should be considered for those clients with true charitable intent. It provides an excellent opportunity for clients to make a non cash, inter vivos gift to charity and receive both an immediate income tax benefit as well as removing the asset from the taxable estate.

Charitable Lead Trust (CLT)

An inter vivos charitable lead trust (CLT) can be an effective estate freezing technique in this economy especially if the contributed assets are expected to appreciate during the term of the trust. This is because the IRS assumes that the CLT's return on its assets will equal the Sec.

7520 rate for the CLT's full duration, even though the trust may be created in a period of low interest rates. To the extent the trust grows in excess of the Sec. 7520 rate, tax-free wealth is passed to the next generation. Additionally, charitable lead annuity trusts (CLATs) are more responsive to lower Sec. 7520 rates in determining the present value of the annuity interest. The lower the Sec. 7520 rate, the higher the income, gift, and estate tax charitable deductions.

A charitable lead trust (CLT) is a trust that pays the income to charity with the remainder to a noncharitable donee. It is an irrevocable trust that typically pays a charitable beneficiary an annuity or unitrust amount for a set term of years. The payment must be a fixed amount or a fixed percentage of the trust's value, re-determined annually. At the end of the trust term, the remaining assets are paid to the grantor or his noncharitable beneficiary. The donor can specify the charity(ies) or allow the trustee to select the charity (ies). A CLT can be created during the donor's lifetime or at death. A CLT can also be considered a grantor trust for income tax purposes under IRC Sec. 671.

A CLT is flexible regarding the trust's term and payout requirements. Unlike a CRT, a CLT has no minimum or maximum annual payout percentage. Actual income over the required payment term may be distributed to charity if the governing instrument allows. Alternatively, the excess income can be added to corpus. The trust's duration is not limited although the duration must be determinable when the trust is created. The longer the charitable term, the larger the charitable deduction will be. But the longer the term, the longer the noncharitable beneficiaries must wait for their share.

A CLT is not tax-exempt in the way that a CRT is. The CLT is taxed like any other trust. Undistributed income is taxed at trust rates. As mentioned, CLT may be subject to the grantor trust rule of IRC Sec. 671. The type of powers given to the donor will determine whether the trust is a grantor trust.

Required Terms of a CLT

A CLT must irrevocably transfer an income interest to its charitable beneficiary. If the income interest can be revoked, no gift or estate tax deduction is allowed. Additionally, there is no income tax deduction if the CLT is an irrevocable grantor trust. The present interest is paid to a charitable organization and the remainder interest either reverts to the donor or is paid to one or

more noncharitable beneficiaries upon termination of the lead interest. To receive a gift or estate tax deduction for the present interest to charity, the interest must qualify under IRC Secs. 2055(e)(2)(B) and 2522(c)(2) and be in the form of a:

a. CLAT – guaranteed annuity interest

b. CLUT – unitrust interest

Charitable Lead Annuity Trust (CLAT)

The charity has a right to receive a defined amount of income that is paid at least annually. For a specified term or the life or lives of one or more individuals, each of whom must be identified and living at the time of the decedent's death. A combination can be used such as "For the life of my daughter plus ten years."

Charitable Lead Unitrust (CLUT)

The charity has a right to receive payment (at least annually) of a fixed percentage of the trust's net FMV, redetermined annually. The charity's payment may be made for a specified term, the life or lives of one or more individuals, each of whom must be identified and living at the decedent's date of death.

Other CLT Requirements

The payment to charity must be made even if the trust's net income for the year is less than the required payment. There is a risk that distributions of corpus to charity would be required if the trust's net income is less than the required if the investment performance failed to meet expectations, eroding the amount available for eventual distribution to the noncharitable beneficiaries. With a CLUT, the charitable and noncharitable beneficiaries share in any appreciation in the value of the corpus. With a CLAT, all appreciation inures to the noncharitable remainderman. If the FMV of the charity's guaranteed annuity or unitrust interest at the date of death exceeds 60% of the FMV of the trust's assets, a charitable lead trust's governing instrument must prohibit both excess business holdings and the acquisition and retention of any assets that would jeopardize the trust's charitable purposes [IRC Sec. 4947(b)(3); Reg. 20.2055-2(e)(2)(vi)(e)

Regardless of the value of the charitable interest, the trust's governing instrument must contain language prohibiting it from engaging in any acts or failing to perform any acts that would cause it to be subject to any of the private foundation excise taxes like self-dealing.

Grantor vs. Non-Grantor CLT

There are big differences between the Non-Grantor CLT and Grantor CLT. A Non-Grantor CLT is taxed as a complex trust on Form 1041 and a charitable deduction is allowed for the CLT payment to charity. Any taxable income remaining is taxed to the trust and the tax is paid by the Trustee. Additionally a Form 5227 is required.

A Grantor CLT is created when the grantor retains either an interest or powers that make the trust a grantor trust for income tax purposes. In this situation, the grantor gets a onetime charitable deduction at the inception of the CLT equal to the present value of the income stream to charity. Any charitable contribution deduction that cannot be used in the inception year is carried over five years. Additionally, any income earned on the trust is taxed to the grantor under the grantor trust rules of IRC Sec. 671. The Grantor CLT arrangement works best when there has been a significant liquidity event to the grantor that generates large income tax consequences.

Because of the ongoing income tax consequences to the grantor in a Grantor CLT, it is suggested that the investment strategy contain the use of tax exempt assets.

Available Tax Deductions

A gift or estate tax charitable deduction is available that is equal to the value of the income interest given to charity. This is the present value of the income stream, determined using IRS actuarial tables. Only the remainder interest passing to the noncharitable beneficiary is subject to gift or estate tax when the trust is funded.

Recapture Issues

If the grantor dies during the term of the Grantor CLT, the trust ceases to be a grantor trust and there is recapture of the charitable income tax deduction that was taken up front. This recapture amount is reduced by any prior payments made to the charity.

GST Issues in CLTs

A charity is not considered a "skip person," For GST purposes, CLATs and CLUTs are treated differently for purposes of the GST exclusion. A CLAT must revalue assets to recompute the applicable fraction when the charitable interest ends. There appreciation in a CLAT is only sheltered from GST to the extent of the Sec. 7520 interest rate with adjustments for the passage of time. However, in a CLUT situation, the asset values are frozen for GST purposes when the exemption is first applied. This makes the CLUT more effective for GST purposes.

Shark Fin CLAT

The "Shark-Fin" CLAT is a fairly new strategy where the payouts to the charity are essentially back-loaded. One version of this strategy would be to use all the funds transferred to the CLAT to purchase a single-premium life insurance policy on the grantor of the CLAT. When the grantor dies, and the CLAT ends, a portion of the life insurance proceeds would be used to fund the substantial back-loaded balloon payment to charity. This strategy was derived when the sample CLAT forms were published in Rev. Proc. 2007-45 and 2007-46. The accompanying annotations to the sample forms stated that the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar amount "but increases during the annuity period." From this language, the "variable CLAT" or "VCLAT" and the "Shark-Fin" CLAT strategies were born. By back-loading the payment to charity, the Shark-Fin CLAT is intended to allow for a significant build-up of funds within the CLAT so as to maximize the amount ultimately passing to family members on the termination of the CLAT. The nominal annual annuity payments and the back-loaded balloon payment can be structured to result in a zeroed-out CLAT. Until the IRS clarifies its position, it is debatable whether these strategies will survive the long term scrutiny of the IRS.

It should be noted that when the FMV is less than the decedent's basis in the asset, the basis will be the same for both federal and California purposes because IRC Sec. 1022 retained the step down and just removed the step up of IRC Sec. 1014.

Caution: *DRAFT—NOT FOR FILING*

This is an early release draft of an IRS tax form, instructions, or publication, which the IRS is providing for your information as a courtesy. **Do not file draft forms.** Also, do not rely on draft instructions and publications for filing. We generally do not release drafts of forms until we believe we have incorporated all changes. However, in some cases unexpected issues arise, or legislation is passed, necessitating a change to a draft form we have posted on IRS.gov. Also, forms generally are subject to OMB approval before they are officially released. Drafts of instructions and publications are usually subject to at least some changes before being officially released.

All early releases of draft forms, instructions, and publications are available at www.IRS.gov/draftforms. All information about forms, instructions, and publications is accessible from www.IRS.gov/formspubs.

If you have any comments on this draft, you can submit them to us on our IRS.gov page titled Comment on Forms and Publications, where you may make comments anonymously if you wish. You can also email us at taxforms@irs.gov. Please include the form or publication number in the subject. We cannot respond to all comments due to the high volume we receive, but we will carefully consider each suggestion. Please note that we may not be able to consider many suggestions until the subsequent revision of the product.

Form **706**

(Rev. August 2012)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

▶ Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2011, and before January 1, 2013.

▶ Information about Form 706 and its separate instructions is at *www.irs.gov/form706.*

OMB No. 1545-0015

Part 1—Decedent and Executor

1a	Decedent's first name and middle initial (and maiden name, if any)	1b Decedent's last name		2 Decedent's social security no.
3a	County, state, and ZIP or postal code, or foreign country, of legal residence (domicile) at time of death	3b Year domicile established	4 Date of birth	5 Date of death
6a	Name of executor (see instructions)	6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP or postal code) and phone no.		
6c	Executor's social security number (see instructions)	Phone no.		
6d	If there are multiple executors, check here ☐ and attach a list showing the names, addresses, telephone numbers, and SSNs of the additional executors.			
7a	Name and location of court where will was probated or estate administered			7b Case number
8	If decedent died testate, check here ▶ ☐ and attach a certified copy of the will.	9 If you extended the time to file this Form 706, check here ▶ ☐		
10	If Schedule R-1 is attached, check here ▶ ☐	11 If you are estimating the value of assets included in the gross estate on line 1 pursuant to the special rule of Reg. section 20.2010-2T(a)(7)(ii), check here ▶ ☐		

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5—Recapitulation, item 13)	1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 24)	2	
3a	Tentative taxable estate (subtract line 2 from line 1)	3a	
b	State death tax deduction	3b	
c	Taxable estate (subtract line 3b from line 3a)	3c	
4	Adjusted taxable gifts (see instructions)	4	
5	Add lines 3c and 4	5	
6	Tentative tax on the amount on line 5 from Table A in the instructions	6	
7	Total gift tax paid or payable (see instructions)	7	
8	Gross estate tax (subtract line 7 from line 6)	8	
9a	Basic exclusion amount	9a	
9b	Deceased spousal unused exclusion (DSUE) amount from predeceased spouse(s), if any (from Section D, Part 6-Portability of Deceased Spousal Unused Exclusion)	9b	
9c	Applicable exclusion amount (add lines 9a and 9b)	9c	
9d	Applicable credit amount (tentative tax on the amount in 9c from Table A in the instructions)	9d	
10	Adjustment to applicable credit amount (May not exceed $6,000. See instructions.)	10	
11	Allowable applicable credit amount (subtract line 10 from line 9d)	11	
12	Subtract line 11 from line 8 (but do not enter less than zero)	12	
13	Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	13	
14	Credit for tax on prior transfers (from Schedule Q)	14	
15	Total credits (add lines 13 and 14)	15	
16	Net estate tax (subtract line 15 from line 12)	16	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)	17	
18	Total transfer taxes (add lines 16 and 17)	18	
19	Prior payments (explain in an attached statement)	19	
20	Balance due (or overpayment) (subtract line 19 from line 18)	20	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Estate of: | **Decedent's social security number**

Part 3—Elections by the Executor

Note. For information on electing portability of the decedent's DSUE amount, including how to opt out of the election, see Section A of Part 6-Portability of Deceased Spousal Unused Exclusion.
Note. Some of these elections may require the posting of bonds or liens.

Please check the "Yes" or "No" box for each question (see instructions).

			Yes	No
1	Do you elect alternate valuation?	1		
2	Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1	2		
3	Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described in the instructions. **Note. By electing section 6166, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	3		
4	Do you elect to postpone the part of the taxes due to a reversionary or remainder interest as described in section 6163?	4		

Part 4—General Information

(Note. Please attach the necessary supplemental documents. **You must attach the death certificate.)** (See instructions)

Authorization to receive confidential tax information under Regs. sec. 601.504(b)(2)(i); to act as the estate's representative before the IRS; and to make written or oral presentations on behalf of the estate:

Name of representative (print or type)	State	Address (number, street, and room or suite no., city, state, and ZIP or postal code)

I declare that I am the ☐ attorney/ ☐ certified public accountant/ ☐ enrolled agent (check the applicable box) for the executor. I am not under suspension or disbarment from practice before the Internal Revenue Service and am qualified to practice in the state shown above.

Signature	CAF number	Date	Telephone number

1 Death certificate number and issuing authority (attach a copy of the death certificate to this return).

2 Decedent's business or occupation. If retired, check here ▶ ☐ and state decedent's former business or occupation.

3a Marital status of the decedent at time of death:
☐ Married ☐ Widow/widower ☐ Single ☐ Legally separated ☐ Divorced

3b For all prior marriages, list the name and SSN of the former spouse, the date the marriage ended, and whether the marriage ended by annulment, divorce, or death. Attach additional statements of the same size if necessary.

4a Surviving spouse's name	4b Social security number	4c Amount received (see instructions)

5 Individuals (other than the surviving spouse), trusts, or other estates who receive benefits from the estate (do not include charitable beneficiaries shown in Schedule O) (see instructions).

Name of individual, trust, or estate receiving $5,000 or more	Identifying number	Relationship to decedent	Amount (see instructions)
All unascertainable beneficiaries and those who receive less than $5,000 ▶			
Total			

If you answer "Yes" to any of the following questions, you must attach additional information as described.	Yes	No
6 Is the estate filing a protective claim for refund? If "Yes," complete and attach two copies of Schedule PC for each claim.		
7 Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate)? (see instructions)		
8a Have federal gift tax returns ever been filed? If "Yes," attach copies of the returns, if available, and furnish the following information:		
b Period(s) covered / c Internal Revenue office(s) where filed		
9a Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?		
b Did the decedent own any insurance on the life of another that is not included in the gross estate?		

Estate of: | **Decedent's social security number**

Part 4—General Information *(continued)*

If you answer "Yes" to any of the following questions, you must attach additional information as described.		Yes	No
10	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which (a) one or more of the other joint tenants was someone other than the decedent's spouse, and (b) less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E		
11a	Did the decedent, at the time of death, own any interest in a partnership (for example, a family limited partnership), an unincorporated business, or a limited liability company; or own any stock in an inactive or closely held corporation?		
b	If "Yes," was the value of any interest owned (from above) discounted on this estate tax return? If "Yes," see the instructions on reporting the total accumulated or effective discounts taken on Schedule F or G		
12	Did the decedent make any transfer described in sections 2035, 2036, 2037, or 2038? (see instructions) If "Yes," you must complete and attach Schedule G		
13a	Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?		
b	Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		
c	Was the decedent receiving income from a trust created after October 22, 1986, by a parent or grandparent?		
	If "Yes," was there a GST taxable termination (under section 2612) on the death of the decedent?		
d	If there was a GST taxable termination (under section 2612), attach a statement to explain. Provide a copy of the trust or will creating the trust, and give the name, address, and phone number of the current trustee(s).		
e	Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in lines 13a or 13b?		
	If "Yes," provide the EIN for this transferred/sold item. ▶		
14	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		
15	Did the decedent have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?		
16	Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I or a private annuity? If "Yes," you must complete and attach Schedule I		
17	Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a predeceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation		

Part 5—Recapitulation.

Note. If estimating the value of one or more assets pursuant to the special rule of Reg. sec. 20.2010-2T(a)(7)(ii), enter on both lines 10 and 23 the amount noted in the instructions for the corresponding range of values. (See instructions for details.)

Item no.	Gross estate		Alternate value	Value at date of death
1	Schedule A—Real Estate	1		
2	Schedule B—Stocks and Bonds	2		
3	Schedule C—Mortgages, Notes, and Cash	3		
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)	4		
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)	5		
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6		
7	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance)	7		
8	Schedule H—Powers of Appointment	8		
9	Schedule I—Annuities	9		
10	Estimated value of assets subject to the special rule of Reg. section 20.2010-2T(a)(7)(ii)	10		
11	Total gross estate (add items 1 through 10)	11		
12	Schedule U—Qualified Conservation Easement Exclusion	12		
13	Total gross estate less exclusion (subtract item 11 from item 10). Enter here and on line 1 of Part 2—Tax Computation	13		

Item no.	Deductions		Amount
14	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims	14	
15	Schedule K—Debts of the Decedent	15	
16	Schedule K—Mortgages and Liens	16	
17	Total of items 14 through 16	17	
18	Allowable amount of deductions from item 17 (see the instructions for item 18 of the Recapitulation)	18	
19	Schedule L—Net Losses During Administration	19	
20	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims	20	
21	Schedule M—Bequests, etc., to Surviving Spouse	21	
22	Schedule O—Charitable, Public, and Similar Gifts and Bequests	22	
23	Estimated value of assets subject to the special rule of Reg. section 20.2010-2T(a)(7)(ii)	23	
24	Tentative total allowable deductions (add items 18 through 23). Enter here and on line 2 of the Tax Computation	24	

Estate of: | **Decedent's social security number**

Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE)

Section A. Portability Election

A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount.

Denial of Portability. The estate of a decedent with a surviving spouse may opt out of electing portability of the DSUE amount. Check here and do not complete Sections B and C of Part 6 only if the estate opts **NOT** to elect portability of the DSUE amount. ☐

Section B. QDOT

	Yes	No
Are any assets of the estate being transferred to a qualified domestic trust (QDOT)?		

If "Yes," the DSUE amount portable to a surviving spouse (calculated in Section C, below) is preliminary and shall be redetermined at the time of the final distribution or other taxable event imposing estate tax under section 2056A. See instructions for more details.

Section C. DSUE Amount Portable to the Surviving Spouse (To be completed by the estate of a decedent making a portability election.)

Complete the following calculation to determine the DSUE amount that can be transferred to the surviving spouse.

1	Enter amount from line 9c, Part 2 - Tax Computation	1	
2	Enter amount from line 5, Part 2 - Tax Computation	2	
3	Subtract line 2 from line 1. (do not enter less than zero)	3	
4	Enter amount from line 7, Part 2 - Tax Computation	4	
5	Divide amount on line 4 by 35% (0.35). If amount on line 4 is zero, enter -0- on line 5	5	
6	Unused exclusion amount (add lines 3 and 5)	6	
7	DSUE amount portable to the surviving spouse (Enter the lesser of line 6 or line 9a, Part 2-Tax Computation)	7	

Section D. DSUE Amount Received from Predeceased Spouse(s) (To be completed by the estate of a surviving spouse with DSUE amount from predeceased spouse(s))

Provide the following information to determine the DSUE amount received from deceased spouses.

A Name of Deceased Spouse (dates of death after December 31, 2010, only)	B Date of Death (enter as mm/dd/yy)	C Portability Election Made?		D If "Yes," DSUE Amount Received from Spouse	E DSUE Amount Applied by Decedent to Lifetime Gifts	F Date(s) of Gift(s) (enter as mm/dd/yy)	G Remaining DSUE Amount, if any (subtract col. E from col. D)
		Yes	No				
Part 1 — DSUE RECEIVED FROM LAST DECEASED SPOUSE							
Part 2 — DSUE RECEIVED FROM OTHER PREDECEASED SPOUSE(S) AND USED BY DECEDENT							
Total (for all DSUE amounts applied)							

Add the amount from Part 1, column D and the total from column E of Part 2. Enter the result on line 9b, Part 2-Tax Computation on page 1 . . . . . . ▶ ________

Estate of: | **Decedent's social security number**

SCHEDULE A—Real Estate

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

August 10, 2012

DO NOT FILE

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules or additional statements attached to this schedule . . .				
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 1.)				

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of: | **Decedent's social security number**

SCHEDULE A-1—Section 2032A Valuation

Part 1. Type of election (Before making an election, see the checklist in the instructions.):

☐ **Protective election (Regulations section 20.2032A-8(b)).** Complete Part 2, line 1, and column A of lines 3 and 4. (see instructions)

☐ **Regular election.** Complete all of Part 2 (including line 11, if applicable) and Part 3. (see instructions)

Before completing Schedule A-1, see the instructions for the information and documents that must be included to make a valid election.

The election is not valid unless the agreement (that is, *Part 3. Agreement to Special Valuation Under Section 2032A*):

- Is signed by each qualified heir with an interest in the specially valued property and
- Is attached to this return when it is filed.

Part 2. Notice of election (Regulations section 20.2032A-8(a)(3))

Note. All real property entered on lines 2 and 3 must also be entered on Schedules A, E, F, G, or H, as applicable.

1 Qualified use—check one ▶ ☐ Farm used for farming, or ☐ Trade or business other than farming

2 Real property used in a qualified use, passing to qualified heirs, and to be specially valued on this Form 706.

A Schedule and item number from Form 706	B Full value (without section 2032A(b)(3)(B) adjustment)	C Adjusted value (with section 2032A (b)(3)(B) adjustment)	D Value based on qualified use (without section 2032A(b)(3)(B) adjustment)
Totals			

Attach a legal description of all property listed on line 2.

Attach copies of appraisals showing the column B values for all property listed on line 2.

3 Real property used in a qualified use, passing to qualified heirs, but not specially valued on this Form 706.

A Schedule and item number from Form 706	B Full value (without section 2032A(b)(3)(B) adjustment)	C Adjusted value (with section 2032A (b)(3)(B) adjustment)	D Value based on qualified use (without section 2032A(b)(3)(B) adjustment)
Totals			

If you checked "Regular election," you must attach copies of appraisals showing the column B values for all property listed on line 3.

(continued on next page)

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4 Personal property used in a qualified use and passing to qualified heirs.

A Schedule and item number from Form 706	B Adjusted value (with section 2032A (b)(3)(B) adjustment)	A (continued) Schedule and item number from Form 706	B (continued) Adjusted value (with section 2032A (b)(3)(B) adjustment)
		"Subtotal" from Col. B, below left	
Subtotal		**Total adjusted value** . . .	

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5 Enter the value of the total gross estate as adjusted under section 2032A(b)(3)(A). ▶

6 **Attach a description of the method used to determine the special value based on qualified use.**

7 Did the decedent and/or a member of his or her family own all property listed on line 2 for at least 5 of the 8 years immediately preceding the date of the decedent's death? . . . . ☐ Yes ☐ No

8 Were there any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family:

		Yes	No
a	Did not own the property listed on line 2?		
b	Did not use the property listed on line 2 in a qualified use?		
c	Did not materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6)?		

If "Yes," to any of the above, you must attach a statement listing the periods. If applicable, describe whether the exceptions of sections 2032A(b)(4) or (5) are met.

9 **Attach affidavits describing the activities constituting material participation and the identity and relationship to the decedent of the material participants.**

10 Persons holding interests. Enter the requested information for each party who received any interest in the specially valued property. **(Each of the qualified heirs receiving an interest in the property must sign the agreement, to be found on Part 3 of this Schedule A-1, and the agreement must be filed with this return.)**

	Name	Address
A		
B		
C		
D		
E		
F		
G		
H		

	Identifying number	Relationship to decedent	Fair market value	Special-use value
A				
B				
C				
D				
E				
F				
G				
H				

You must attach a computation of the GST tax savings attributable to direct skips for each person listed above who is a skip person. (see instructions)

11 **Woodlands election.** Check here ▶ ☐ if you wish to make a Woodlands election as described in section 2032A(e)(13). Enter the schedule and item numbers from Form 706 of the property for which you are making this election ▶ ____________

You must attach a statement explaining why you are entitled to make this election. The IRS may issue regulations that require more information to substantiate this election. You will be notified by the IRS if you must supply further information.

Part 3. Agreement to Special Valuation Under Section 2032A

Estate of:	Decedent's social security number

There cannot be a valid election unless:

- The agreement is executed by each one of the qualified heirs and
- The agreement is included with the estate tax return when the estate tax return is filed.

We (list all qualified heirs and other persons having an interest in the property required to sign this agreement) ______________________________,

being all the qualified heirs and ______________________________,

being all other parties having interests in the property which is qualified real property and which is valued under section 2032A of the Internal Revenue Code, do hereby approve of the election made by ______________________________,

Executor/Administrator of the estate of ______________________________,

pursuant to section 2032A to value said property on the basis of the qualified use to which the property is devoted and do hereby enter into this agreement pursuant to section 2032A(d).

The undersigned agree and consent to the application of subsection (c) of section 2032A with respect to all the property described on Form 706, Schedule A-1, Part 2, line 2, attached to this agreement. More specifically, the undersigned heirs expressly agree and consent to personal liability under subsection (c) of 2032A for the additional estate and GST taxes imposed by that subsection with respect to their respective interests in the above-described property in the event of certain early dispositions of the property or early cessation of the qualified use of the property. It is understood that if a qualified heir disposes of any interest in qualified real property to any member of his or her family, such member may thereafter be treated as the qualified heir with respect to such interest upon filing a Form 706-A, United States Additional Estate Tax Return, and a new agreement.

The undersigned interested parties who are not qualified heirs consent to the collection of any additional estate and GST taxes imposed under section 2032A(c) from the specially valued property.

If there is a disposition of any interest which passes, or has passed to him or her, or if there is a cessation of the qualified use of any specially valued property which passes or passed to him or her, each of the undersigned heirs agrees to file a Form 706-A, and pay any additional estate and GST taxes due within 6 months of the disposition or cessation.

It is understood by all interested parties that this agreement is a condition precedent to the election of special-use valuation under section 2032A and must be executed by every interested party even though that person may not have received the estate (or GST) tax benefits or be in possession of such property.

Each of the undersigned understands that by making this election, a lien will be created and recorded pursuant to section 6324B of the Code on the property referred to in this agreement for the adjusted tax differences with respect to the estate as defined in section 2032A(c)(2)(C).

As the interested parties, the undersigned designate the following individual as their agent for all dealings with the Internal Revenue Service concerning the continued qualification of the specially valued property under section 2032A and on all issues regarding the special lien under section 6324B. The agent is authorized to act for the parties with respect to all dealings with the Internal Revenue Service on matters affecting the qualified real property described earlier. This includes the authorization:

- To receive confidential information on all matters relating to continued qualification under section 2032A of the specially valued real property and on all matters relating to the special lien arising under section 6324B;
- To furnish the Internal Revenue Service with any requested information concerning the property;
- To notify the Internal Revenue Service of any disposition or cessation of qualified use of any part of the property;
- To receive, but not to endorse and collect, checks in payment of any refund of Internal Revenue taxes, penalties, or interest;
- To execute waivers (including offers of waivers) of restrictions on assessment or collection of deficiencies in tax and waivers of notice of disallowance of a claim for credit or refund; and
- To execute closing agreements under section 7121.

(continued on next page)

Part 3. Agreement to Special Valuation Under Section 2032A *(continued)*

Estate of: | **Decedent's social security number**

- Other acts (specify) ▶ ______

By signing this agreement, the agent agrees to provide the Internal Revenue Service with any requested information concerning this property and to notify the Internal Revenue Service of any disposition or cessation of the qualified use of any part of this property.

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Name of Agent	Signature	Address

The property to which this agreement relates is listed in Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and in the Notice of Election, along with its fair market value according to section 2031 of the Code and its special-use value according to section 2032A. The name, address, social security number, and interest (including the value) of each of the undersigned in this property are as set forth in the attached Notice of Election.

IN WITNESS WHEREOF, the undersigned have hereunto set their hands at ______,

this ______ day of ______.

DO NOT FILE

SIGNATURES OF EACH OF THE QUALIFIED HEIRS:

Signature of qualified heir	Signature of qualified heir
Signature of qualified heir	Signature of qualified heir
Signature of qualified heir	Signature of qualified heir
Signature of qualified heir	Signature of qualified heir
Signature of qualified heir	Signature of qualified heir
Signature of qualified heir	Signature of qualified heir

Signatures of other interested parties

Signatures of other interested parties

Estate of: | Decedent's social security number

SCHEDULE B—Stocks and Bonds

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

Item number	Description, including face amount of bonds or number of shares and par value for identification. Give CUSIP number. If trust, partnership, or closely held entity, give EIN.	CUSIP number or EIN, where applicable	Unit value	Alternate valuation date	Alternate value	Value at date of death
1						
Total from continuation schedules (or additional statements) attached to this schedule . . .						
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 2.)						

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

August 16, 2012
DO NOT FILE

Estate of: | **Decedent's social security number**

SCHEDULE C—Mortgages, Notes, and Cash

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules (or additional statements) attached to this schedule				
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 3.)				

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of:	Decedent's social security number

SCHEDULE D—Insurance on the Decedent's Life

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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August 16, 2012
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Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules (or additional statements) attached to this schedule . .				
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 4.)				

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of:	Decedent's social security number

SCHEDULE E—Jointly Owned Property

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of Part 1 of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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

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

August 16, 2012
DO NOT FILE

PART 2. All Other Joint Interests

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

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

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

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of: | **Decedent's social security number**

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

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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

DO NOT FILE

Item number	Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN	CUSIP number or EIN, where applicable	Alternate valuation date	Alternate value	Value at date of death
1					
Total from continuation schedules (or additional statements) attached to this schedule . .					
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 6.)					

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of: | Decedent's social security number

SCHEDULE G—Transfers During Decedent's Life

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

Item number	Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN	Alternate valuation date	Alternate value	Value at date of death
A.	Gift tax paid or payable by the decedent or the estate for all gifts made by the decedent or his or her spouse within 3 years before the decedent's death (section 2035(b))	X X X X X		
B.	Transfers includible under sections 2035(a), 2036, 2037, or 2038:			
1				
	Total from continuation schedules (or additional statements) attached to this schedule . .			
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 7.)			

August 10, 2012
DO NOT FILE

SCHEDULE H—Powers of Appointment

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
	Total from continuation schedules (or additional statements) attached to this schedule . . .			
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 8.)			

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of:	Decedent's social security number

SCHEDULE I—Annuities

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value in the last 3 columns of this schedule. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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

Item number	Description. Show the entire value of the annuity before any exclusions	Alternate valuation date	Includible alternate value	Includible value at date of death
1				
Total from continuation schedules (or additional statements) attached to this schedule . .				
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 9.)				

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

DRAFT AS OF August 16, 2012 DO NOT FILE

Estate of: | Decedent's social security number

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

▶ **Use Schedule PC to make a protective claim for refund due to an expense not currently deductible. For such a claim, report the expense on Schedule J but without a value in the last column.**

Note. Do not list expenses of administering property not subject to claims on this schedule. To report those expenses, see instructions.

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

	Yes	No
Are you aware of any actual or potential reimbursement to the estate for any expense claimed as a deduction on this schedule?		
If "Yes," attach a statement describing the expense(s) subject to potential reimbursement. (see instructions)		

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Item number	Description	Expense amount	Total amount
	A. Funeral expenses:		
1			
	Total funeral expenses . . . . ▶		

B. Administration expenses:

1 Executors' commissions—amount estimated/agreed upon/paid. (Strike out the words that do not apply.)	
2 Attorney fees—amount estimated/agreed upon/paid. (Strike out the words that do not apply.) . . .	
3 Accountant fees—amount estimated/agreed upon/paid. (Strike out the words that do not apply.) . .	

	4 Miscellaneous expenses:	Expense amount	
	Total miscellaneous expenses from continuation schedules (or additional statements) attached to this schedule		
	Total miscellaneous expenses . . . . ▶		
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 14.) . . . . ▶		

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of:	Decedent's social security number

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

▶ Use Schedule PC to make a protective claim for refund due to a claim not currently deductible. For such a claim, report the claim on Schedule K but without a value in the last column.

	Yes	No
Are you aware of any actual or potential reimbursement to the estate for any debt of the decedent, mortgage, or lien claimed as a deduction on this schedule?		
If "Yes," attach a statement describing the items subject to potential reimbursement. (see instructions)		
Are any of the items on this schedule deductible under Reg. section 20.2053-4(b) and Reg. section 20.2053-4(c)?		
If "Yes," attach a statement indicating the applicable provision and documenting the value of the claim.		

Item number	Debts of the Decedent—Creditor and nature of debt, and allowable death taxes	Amount
1		
	Total from continuation schedules (or additional statements) attached to this schedule	
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 15.)	

August 16, 2012
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Item number	Mortgages and Liens—Description	Amount
1		
	Total from continuation schedules (or additional statements) attached to this schedule	
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 16.)	

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of:	Decedent's social security number

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

▶ Use Schedule PC to make a protective claim for refund due to an expense not currently deductible. For such expenses, report the expense on Schedule L but without a value in the last column.

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Item number	Net losses during administration (Note. Do not deduct losses claimed on a federal income tax return.)	Amount
1		
	Total from continuation schedules (or additional statements) attached to this schedule	
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 19.)	

Item number	Expenses incurred in administering property not subject to claims. (Indicate whether estimated, agreed upon, or paid.)	Amount
1		
	Total from continuation schedules (or additional statements) attached to this schedule	
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 20.)	

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of: | **Decedent's social security number**

SCHEDULE M—Bequests, etc., to Surviving Spouse

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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

Item number	Description of property interests passing to surviving spouse. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN	Amount
	QTIP property:	
A1		
	All other property:	
B1		
	Total from continuation schedules (or additional statements) attached to this schedule	

4	**Total** amount of property interests listed on Schedule M		4	
5a	Federal estate taxes payable out of property interests listed on Schedule M	5a		
b	Other death taxes payable out of property interests listed on Schedule M	5b		
c	Federal and state GST taxes payable out of property interests listed on Schedule M	5c		
d	Add items 5a, 5b, and 5c		5d	
6	Net amount of property interests listed on Schedule M (subtract 5d from 4). Also enter on Part 5—Recapitulation, page 3, at item 21		6	

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

Estate of: | **Decedent's social security number**

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

Note. Each asset (if any) on this schedule to which the special rule of Reg. sec. 20.2010-2T(a)(7)(ii) applies shall be reported on this schedule, but without any value. See instructions for information on how to estimate and report the total value of such property on lines 10 and 23 of Part 5-Recapitulation.

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

Item number	Name and address of beneficiary	Character of institution	Amount
1			
Total from continuation schedules (or additional statements) attached to this schedule			

3	Total			3	
4a	Federal estate tax payable out of property interests listed above	4a			
b	Other death taxes payable out of property interests listed above	4b			
c	Federal and state GST taxes payable out of property interests listed above .	4c			
d	Add items 4a, 4b, and 4c			4d	
5	Net value of property interests listed above (subtract 4d from 3). Also enter on Part 5—Recapitulation, page 3, at item 22			5	

(If more space is needed, attach the continuation schedule from the end of this package or additional statements of the same size.)

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Estate of:	Decedent's social security number

SCHEDULE P—Credit for Foreign Death Taxes

List all foreign countries to which death taxes have been paid and for which a credit is claimed on this return.

If a credit is claimed for death taxes paid to more than one foreign country, compute the credit for taxes paid to one country on this sheet and attach a separate copy of Schedule P for each of the other countries.

The credit computed on this sheet is for the ____________ (Name of death tax or taxes)

____________ imposed in ____________ (Name of country)

Credit is computed under the ____________ (Insert title of treaty or statute)

Citizenship (nationality) of decedent at time of death ____________

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(All amounts and values must be entered in United States money.)

1	Total of estate, inheritance, legacy, and succession taxes imposed in the country named above attributable to property situated in that country, subjected to these taxes, and included in the gross estate (as defined by statute)	1	
2	Value of the gross estate (adjusted, if necessary, according to the instructions)	2	
3	Value of property situated in that country, subjected to death taxes imposed in that country, and included in the gross estate (adjusted, if necessary, according to the instructions)	3	
4	Tax imposed by section 2001 reduced by the total credits claimed under sections 2010 and 2012 (see instructions)	4	
5	Amount of federal estate tax attributable to property specified at item 3. (Divide item 3 by item 2 and multiply the result by item 4.)	5	
6	Credit for death taxes imposed in the country named above (the smaller of item 1 or item 5). Also enter on line 13 of Part 2—Tax Computation	6	

SCHEDULE Q—Credit for Tax on Prior Transfers

Part 1. Transferor Information

	Name of transferor	Social security number	IRS office where estate tax return was filed	Date of death
A				
B				
C				

Check here ▶ ☐ if section 2013(f) (special valuation of farm, etc., real property) adjustments to the computation of the credit were made (see instructions).

Part 2. Computation of Credit (see instructions)

Item	Transferor A	Transferor B	Transferor C	Total A, B, & C
1 Transferee's tax as apportioned (from worksheet, (line 7 ÷ line 8) × line 35 for each column)				
2 Transferor's tax (from each column of worksheet, line 20)				
3 Maximum amount before percentage requirement (for each column, enter amount from line 1 or 2, whichever is smaller)				
4 Percentage allowed (each column) (see instructions)	%	%	%	
5 Credit allowable (line 3 × line 4 for each column)				
6 TOTAL credit allowable (add columns A, B, and C of line 5). Enter here and on line 14 of Part 2—Tax Computation				

SCHEDULE R—Generation-Skipping Transfer Tax

Note. To avoid application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under section 2612 even if the form is not required to be filed to report estate or GST tax.

The GST tax is imposed on taxable transfers of interests in property located outside the United States as well as property located inside the United States. (see instructions)

Part 1. GST Exemption Reconciliation (Section 2631) and Special QTIP Election (Section 2652(a)(3))

You no longer need to check a box to make a section 2652(a)(3) (special QTIP) election. If you list qualifying property in Part 1, line 9 below, you will be considered to have made this election. See instructions for details.

August 16 2012

1	Maximum allowable GST exemption	1	
2	Total GST exemption allocated by the decedent against decedent's lifetime transfers	2	
3	Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers	3	
4	GST exemption allocated on line 6 of Schedule R, Part 2	4	
5	GST exemption allocated on line 6 of Schedule R, Part 3	5	
6	Total GST exemption allocated on line 4 of Schedule(s) R-1	6	
7	Total GST exemption allocated to *inter vivos* transfers and direct skips (add lines 2–6)	7	
8	GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1)	8	

DO NOT FILE

9 Allocation of GST exemption to trusts (as defined for GST tax purposes):

A Name of trust	B Trust's EIN (if any)	C GST exemption allocated on lines 2–6, above (see instructions)	D Additional GST exemption allocated (see instructions)	E Trust's inclusion ratio (optional—see instructions)

9D Total. May not exceed line 8, above 9D

10 GST exemption available to allocate to section 2032A interests received by individual beneficiaries (subtract line 9D from line 8). You must attach special-use allocation statement (see instructions) . 10

Estate of: | **Decedent's social security number**

Part 2. Direct Skips Where the Property Interests Transferred Bear the GST Tax on the Direct Skips

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Name of skip person	Description of property interest transferred	Estate tax value

1	Total estate tax values of all property interests listed above	1	
2	Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3	GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 2 (see instructions)	3	
4	Total fixed taxes and other charges (add lines 2 and 3)	4	
5	Total tentative maximum direct skips (subtract line 4 from line 1)	5	
6	GST exemption allocated	6	
7	Subtract line 6 from line 5	7	
8	GST tax due (divide line 7 by 3.857143)	8	
9	Enter the amount from line 8 of Schedule R, Part 3	9	
10	**Total GST taxes payable by the estate** (add lines 8 and 9). Enter here and on line 17 of Part 2—Tax Computation	10	

Estate of: | **Decedent's social security number**

Part 3. Direct Skips Where the Property Interests Transferred Do Not Bear the GST Tax on the Direct Skips

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Name of skip person	Description of property interest transferred	Estate tax value

		Line	Amount
1	Total estate tax values of all property interests listed above	1	
2	Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3	GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 3 (see instructions)	3	
4	Total fixed taxes and other charges (add lines 2 and 3)	4	
5	Total tentative maximum direct skips (subtract line 4 from line 1)	5	
6	GST exemption allocated	6	
7	Subtract line 6 from line 5	7	
8	GST tax due (multiply line 7 by .35). Enter here and on Schedule R, Part 2, line 9	8	

SCHEDULE R-1 (Form 706)
(Rev. August 2012)
Department of the Treasury
Internal Revenue Service

Generation-Skipping Transfer Tax

Direct Skips From a Trust
Payment Voucher

OMB No. 1545-0015

Executor: File one copy with Form 706 and send two copies to the fiduciary. Do not pay the tax shown. See instructions for details.
Fiduciary: See instructions for details. Pay the tax shown on line 6.

Name of trust		Trust's EIN
Name and title of fiduciary	Name of decedent	
Address of fiduciary (number and street)	Decedent's SSN	Service Center where Form 706 was filed
City, state, and ZIP or postal code	Name of executor	
Address of executor (number and street)	City, state, and ZIP or postal code	
Date of decedent's death	Filing due date of Schedule R, Form 706 (with extensions)	

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Part 1. Computation of the GST Tax on the Direct Skip

Description of property interests subject to the direct skip	Estate tax value

1	Total estate tax value of all property interests listed above	1	
2	Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3	Tentative maximum direct skip from trust (subtract line 2 from line 1)	3	
4	GST exemption allocated	4	
5	Subtract line 4 from line 3	5	
6	**GST tax due from fiduciary** (divide line 5 by 3.857143). **(See instructions if property will not bear the GST tax.)**	6	

Under penalties of perjury, I declare that I have examined this document, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature(s) of executor(s) ______ Date ______

______ Date ______

Signature of fiduciary or officer representing fiduciary ______ Date ______

Instructions for the Trustee

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Introduction

Schedule R-1 (Form 706) serves as a payment voucher for the Generation-Skipping Transfer (GST) tax imposed on a direct skip from a trust, which you, the trustee of the trust, must pay. The executor completes the Schedule R-1 (Form 706) and gives you two copies. File one copy and keep one for your records.

How to pay

You can pay by check or money order or by electronic funds transfer.

To pay by check or money order:

- Make it payable to "United States Treasury"
- The amount of the check or money order should be the amount on line 6 of Schedule R-1.
- Write "GST Tax" and the trust's EIN on the check or money order.

To pay by electronic funds transfer:

- Funds must be submitted through the Electronic Federal Tax Payment System (EFTPS).
- Establish an EFTPS account by visiting *www.eftps.gov* or calling 1-800-555-4477.
- Payments made through EFTPS must be completed no later than 8 p.m. Eastern time the day **before** the due date to be considered timely.

Signature

You must sign the Schedule R-1 in the space provided.

What to mail

Mail your check or money order, if applicable and the copy of Schedule R-1 that you signed.

Where to mail

Mail to the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999.

When to pay

The GST tax is due and payable 9 months after the decedent's date of death (shown on the Schedule R-1). You will owe interest on any GST tax not paid by that date.

Automatic extension

You have an automatic extension of time to file Schedule R-1 and pay the GST tax. The automatic extension allows you to file and pay by 2 months after the due date (with extensions) for filing the decedent's Schedule R (shown on the Schedule R-1).

If you pay the GST tax under the automatic extension, you will be charged interest (but no penalties).

Additional information

For more information, see section 2603(a)(2) and the Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.

Estate of: | **Decedent's social security number**

SCHEDULE U—Qualified Conservation Easement Exclusion

Part 1. Election

Note. The executor is deemed to have made the election under section 2031(c)(6) if he or she files Schedule U and excludes any qualifying conservation easements from the gross estate.

Part 2. General Qualifications

1 Describe the land subject to the qualified conservation easement (see instructions)

2 Did the decedent or a member of the decedent's family own the land described above during the 3-year period ending on the date of the decedent's death? . . . . ☐ Yes ☐ No

3 Describe the conservation easement with regard to which the exclusion is being claimed (see instructions).

Part 3. Computation of Exclusion

4	Estate tax value of the land subject to the qualified conservation easement (see instructions)			4	
5	Date of death value of any easements granted prior to decedent's death and included on line 10 below (see instructions)	5			
6	Add lines 4 and 5	6			
7	Value of retained development rights on the land (see instructions)	7			
8	Subtract line 7 from line 6	8			
9	Multiply line 8 by 30% (.30)	9			
10	Value of qualified conservation easement for which the exclusion is being claimed (see instructions)	10			
	Note. If line 10 is less than line 9, continue with line 11. If line 10 is equal to or more than line 9, skip lines 11 through 13, enter ".40" on line 14, and complete the schedule.				
11	Divide line 10 by line 8. Figure to 3 decimal places (for example, ".123")	11			
	Note. If line 11 is equal to or less than .100, stop here; the estate does not qualify for the conservation easement exclusion.				
12	Subtract line 11 from .300. Enter the answer in hundredths by rounding any thousandths up to the next higher hundredth (that is, .030 = .03, but .031 = .04)	12			
13	Multiply line 12 by 2	13			
14	Subtract line 13 from .40	14			
15	Deduction under section 2055(f) for the conservation easement (see instructions)	15			
16	Amount of indebtedness on the land (see instructions)	16			
17	Total reductions in value (add lines 7, 15, and 16)			17	
18	Net value of land (subtract line 17 from line 4)			18	
19	Multiply line 18 by line 14			19	
20	Enter the smaller of line 19 or the exclusion limitation (see instructions). Also enter this amount on item 12, Part 5—Recapitulation, page 3			20	

Schedule **PC**

(Rev. August 2012)
Department of the Treasury
Internal Revenue Service

Protective Claim for Refund

▶ **To be used for decedents dying after December 31, 2011. File 2 copies of this schedule with Form 706 for each pending claim or expense under section 2053.**

OMB No. 1545-0015

- Timely filing a protective claim for refund preserves the estate's right to claim a refund based on the amount of an unresolved claim or expense that may not become deductible under section 2053 until after the limitation period ends.
- Schedule PC can be used to file a protective claim for refund and, once the claim or expense becomes deductible, Schedule PC can be used to notify the IRS that a refund is being claimed.
- Schedule PC can be used by the estate of a decedent dying after 2011.
- Schedule PC must be filed with Form 706 and cannot be filed separately. (To file a protective claim for refund or notify the IRS that a refund is being claimed in a form separate from the Form 706, instead use Form 843, Claim for Refund and Request for Abatement.)
- Each separate claim or expense requires a separate Schedule PC (or Form 843, if not filed with Form 706).
- Schedule PC must be filed in duplicate (two copies) for each separate claim or expense.

Part 1. General Information

1. Name of decedent	**2.** Decedent's social security number
3. Name of fiduciary	**4.** Date of death
5a. Address (number, street, and room or suite no.)	**5b.** Room or suite no.
5c. City or town, state, and ZIP or postal code	**6.** Daytime telephone number

7. Number of Claims. Enter number of Schedules PC being filed with Form 706. __________

If the number is greater than one OR if another Schedule PC or Form 843 was previously filed by or on behalf of the estate, complete Part 3 of this Schedule PC.

8. Fiduciary ☐ Check here if this Schedule PC is being filed with the original Form 706 or is being filed by the same fiduciary who filed the original Form 706 for decedent's estate. If a different fiduciary is filing this Schedule PC, see Schedule PC instructions for establishing the legal authority to pursue the claim for refund on behalf of the estate.

Part 2. Claim Information

a. ☐ Protective claim for refund made for unresolved claim or expense.

Amount in contest: __________

b. ☐ Partial refund claimed: partial resolution and/or satisfaction of claim or expense for which a protective claim for refund has been filed previously.

Date protective claim for refund filed for this claim or expense: __________

Amount of claim or expense partially resolved and/or satisfied and presently claimed as a deduction under section 2053 (do not include amounts previously deducted): __________

c. ☐ Full and final refund claimed for this claim or expense: resolution and/or satisfaction of claim or expense for which a protective claim for refund has been filed previously.

Date protective claim for refund filed for this claim or expense: __________

Amount of claim or expense finally resolved and/or satisfied and presently claimed as a deduction under section 2053 (do not include amounts previously deducted): __________

Estate of: | **Decedent's social security number**

A Form 706 Schedule and Item number	B **Identification of the claim** • Name or names of the claimant(s) • Basis of the claim or other description of the pending claim or expense • Reasons and contingencies delaying resolution •Status of contested matters •Attach copies of relevant pleadings or other documents	C Amount, if any, deducted under Treas. Reg. sections 20.2053-1(d)(4) or 20.2053-4(b) or (c) for the identified claim or expense	D Amount presently claimed as a deduction under section 2053 for the identified claim	E Ancillary expenses estimated/ agreed upon/paid (Please indicate)	F Amount of tax to be refunded

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Part 3. Other Schedules PC and Forms 843 Filed by Estate

If a Schedule PC or Form 843 was previously filed by the estate, complete Part 3 to identify each claim for refund reported.

A Date of death	B Internal Revenue office where filed	C Date filed	D Indicate whether (1) Protective Claim for Refund; (2) Partial Claim for Refund; or (3) Full and Final Claim for Refund	E Amount in Contest
1				

To inquire about the receipt and/or processing of the protective claim for refund, please call (866) 699-4083.

Estate of: | **Decedent's social security number**

CONTINUATION SCHEDULE

Continuation of Schedule ______
(Enter letter of schedule you are continuing.)

Item number	Description. For securities, give CUSIP number. If trust, partnership, or closely held entity, give EIN.	Unit value (Sch. B, E, or G only)	Alternate valuation date	Alternate value	Value at date of death or amount deductible

TOTAL. (Carry forward to main schedule.) . . . .

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