

Estate Tax Returns: Key Concepts for Estate Planning Counsel

Identifying Taxable Assets and Leveraging Available Deductions and Major Elections

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Estate Tax Returns: Key Concepts for Estate Planning Counsel

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FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Transfer taxes are imposed on gratuitous property transfers
 - Estate taxes are imposed on death transfers
- The tax is based on the property's FMV, not its basis
 - FMV: price at which the property would change hands between a willing buyer and seller, neither being under any compulsion to buy or sell, and both having knowledge of the relevant facts
 - Based on highest and best use not actual use
- Transfer taxes are cumulative
 - Adjusted taxable gifts are added to the taxable estate

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Form 706
 - Must be filed if Decedent's gross estate (GE) plus adjusted taxable gifts exceed \$5,120,000 in 2012 and \$5,250,000 in 2013
 - Applies to all US citizens and residents
 - Form is due nine months after Decedent's death (based on domicile)
 - Example: if Joe died on July 15, 2012, form is due April 15, 2013
 - Form is mailed to: Internal Revenue Service Center, Cincinnati, OH 45999
 - Nonresident forms are filed at: Internal Revenue Service Center, Philadelphia, PA 19255
 - Automatic six month extension to file is available by filing Form 4768
 - Tax liability payable nine months after death unless permission to pay late obtained (interest is charged on any amount not paid nine months after death); Form 4768 filed to obtain extension to pay tax
 - Include any filed Form 709s with Form 706

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Scheme for calculating Federal Estate Tax (FET)
 - Compute Gross Estate (Schedules A-I) (Reported on Line 1)
 - Subtract available deductions (Schedules J-O) (Reported on Line 2)
 - Subtract any state tax deduction (Reported on Line 3b)
 - Equals Taxable Estate (Reported on Line 3c)
 - Add any Adjusted Taxable Gifts (Taxable gifts made since 1977) (Reported on Line 4)
 - Equals Taxable Base (Reported on Line 5)
 - Compute tax on Base (Reported on Line 6) – **KEY POINT**
 - Subtract any gift tax actually paid on adjusted taxable gifts (Reported on Line 7)
 - Subtract all available credits (Lines 11 and 15)
 - If tax exceeds credits, pay excess

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Elections – Part 3
 - Alternative valuation
 - Normally, property in GE valued at date of death value
 - Can elect to value property on alternative valuate date if
 - Total GE value less
 - Net taxes due less
 - All or nothing election
 - Special-use valuation
 - If GE includes real estate, can elect to reduce date of death value
 - Maximum reduction \$1,040,000 (2012) and \$1,070,000 (2013)
 - Specific rules and heirs must sign an agreement
 - Section 6166
 - Installment payments for taxes due on closely-held business
 - Section 6163
 - Taxes due on remainder interest included in GE

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Gross estate
 - All property owned by the Decedent at death is included in the GE
 - Property is valued at FMV date of death (highest and best use) using the accrual basis of accounting
 - State law determines the character of property while the tax code determines its taxation
 - Assets are reported on various schedules, based on character
 - Provide sufficient information about property and its value with return
 - Whether Decedent uses probate or nonprobate to transfer property, property included in GE based on tax laws
 - Nonprobate transfers: deed, contract and trust
 - Classifications of property
 - Interests owned at death
 - Transfers with a retained interest
 - Transfers within three years of death

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Interests owned at death
 - Section 2033
 - All probate property included in GE
 - Only Decedent's interest included (i.e. ½ of community property)
 - Life estate not included in GE
 - Section 2039
 - Annuities, Retirement plans and IRAs included if someone will inherit
 - Section 2040
 - Joint tenancy with right of survivorship
 - Section 2041
 - General powers of appointment
 - Section 2042
 - Life insurance where Decedent was insured
 - Must report all insurance on which Decedent was the insured using Form 712 whether in GE or not
 - Section 2044 (QTIP)

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Transfers with retained interests
 - Sections 2036-38
 - Gifts made during life in which Decedent retained an interest in property gifted
 - Interest includes economic and control
 - Incomplete transfers at death included in GE (i.e. gift checks)
 - Prevents avoiding estate taxes through lifetime transfers
 - Example:
 - Mom gifts total ownership in home during life to child
 - Mom lives in home rent free until death
 - Home included in GE at full value

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Three year rule
 - Does not apply to completed gifts made within three years of death
 - Applies to:
 - Transfers of life insurance by Decedent where Decedent was insured
 - Transfers of retained interests where retained interest removed
 - FGT paid within three years of death

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule A
 - Report all real estate owned by Decedent individually
 - Tenant in common reported on Schedule A, but joint tenancy property reported on Schedule E
 - Include appraisals and any other information necessary to support what was owned and its value (better to over report than underreport)
 - Community property: include full value and subtract $\frac{1}{2}$
 - Report any accrued income associated with real property separately but with asset to which income relates
 - Mortgaged property
 - Recourse – report full value and deduct mortgage on Schedule K (cross reference)
 - Nonrecourse – report the value of the property net of any mortgage
- Schedule A-1
 - Completed if special-use valuation election is made

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule B
 - List each stock or security owned individually
 - Include any accrued income with each asset
 - Valuation: the mean of the high and low value on the date of death
 - Closely-held stock: include an appraisal of business
- Schedule C
 - Report any mortgages, notes or cash owned by Decedent individually
 - Audit trap: cash in possession
- Schedule D
 - Report all insurance where Decedent was the insured
 - Insurance proceeds included in GE if Decedent owned policy or proceeds paid to Decedent's estate
 - Include Form 712 for each policy

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule E
 - Report joint tenancy with right of survivorship property
 - Report qualified joint tenancy property reported in Part 1 and Other in Part 2
 - Qualified
 - Owed solely by spouses and acquired after 1976
 - Irrelevant who's funds were used to acquire property
 - $\frac{1}{2}$ included in GE
 - Other
 - Based on what percentage of purchase price was paid by Decedent
 - Example:
 - Decedent and Joe purchased Blackacre as joint tenants
 - Decedent paid 60% and Joe paid 40%
 - FMV at death - \$750,000
 - \$450,000 included in GE ($\$750,000 * 60\%$)

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule F
 - Catchall schedule: assets included in GE and not reported on another schedule reported on Schedule F
 - Audit trap: no or limited personal assets
 - Report sole proprietorships, partnerships and LLC interests
 - Report property included under a QTIP election
- Schedule G
 - Retained interests and three year rule
 - Revocable trusts reported on Schedule G
 - Charitable remainder trusts reported on Schedule G
 - Include same information as on other schedules to report assets included in trusts

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule H
 - Assets covered by a general power of appointment (GPOA)
 - GPOA: power given Decedent where Decedent could distribute property to
 - Decedent
 - Decedent's creditors
 - Decedent's estate or
 - Creditors of Decedent's estate
- Schedule I
 - Payments made by contract to someone after Decedent's death
 - Decedent must have right to funds during life
 - Value:
 - If payment only made in installments, present value of payments
 - If payment could be made in a lump sum, value of payment at death, even if installment payments are elected

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule J
 - Funeral expenses and administrative expenses
 - Only reasonable funeral expenses are deductible (based on state law)
 - Administrative expenses
 - Transmission: expenses incurred because Decedent died
 - Management: expenses to preserve and maintain assets included in GE
 - Expenses paid on behalf of beneficiaries are not deductible
- Schedule K
 - All debts owed by Decedent are deductible
 - Use accrual accounting to compute debts owed
 - Medical expenses of last illness can be deducted either on Form 706 or 1040
- Schedule L
 - Casualty and theft losses incurred during administration on assets in GE
 - Defined using income tax rules

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule M
 - Deduction for value of property transferred to surviving spouse
 - Mandatory deduction
 - Unlimited for US citizen spouse
 - Must use a QDOT trust if spouse not a US citizen (Form 706-QDT)
 - Must meet rules: asset must be in GE, not subject to a terminable interest
 - QTIP election allowed to avoid terminable interest rule
 - Does not avoid taxes, merely defers when assets will be taxed
- Schedule O
 - Deduction for property Decedent transfers to a qualified charity
 - Unlimited deduction
 - Partial interests (i.e. trusts) must meet certain rules

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Credits - Nonrefundable
- Applicable credit - \$1,772,800 (2012); \$2,045,800 (2013)
 - Can take entire credit even if partially used during life
 - Equals tax on \$5,120,000 (2012); \$5,250,000 (2013)
 - Marginal tax rate: 35% (2012); 40% (2013)
- Schedule P
 - Credit available if taxes paid to foreign government on assets in GE
- Schedule Q
 - FET paid on property received by Decedent within 10 years of death
 - Must get Form 706 of person who paid FET and transferred property to Decedent

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Schedule R and R-1
 - Report any generation-skipping transfers made by Decedent at death
 - If GST is payable by the estate use Schedule R
 - If GST is payable by a trust that is included in GE and the executor is not the trustee, use Schedule R-1 if the trust is making a direct skip
 - Any unused exemption can be used at death

FORM 706 – ESTATE TAX RETURN FUNDAMENTALS

- Points to remember
 - Better to include too much information than too little
 - Use the accrual basis of accounting (a balance sheet for a dead person)
 - It is the executor's responsibility to prove what is on the form
 - Determine what assets are in the GE before computing value
 - Only the Decedent's expenses and debts can be deducted