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# Estate Planning for Forest Landowners: What Will Become of Your Timberland?

William C. Siegel, Harry L. Haney, Jr., and John L. Greene



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## **Abstract**

The purpose of this book is to provide guidelines and assistance to nonindustrial private forest owners and the legal, tax, financial, insurance, and forestry professionals who serve them on the application of estate planning techniques to forest properties. The book presents a working knowledge of the Federal estate and gift tax law as of September 30, 2008, with particular focus on the unique characteristics of owning timber and forest land. It consists of four major parts, plus appendices. Part I develops the practical and legal foundation for estate planning. Part II explains and illustrates the use of general estate planning tools. Part III explains and illustrates the use of additional tools that are specific to forest ownership. Part IV describes the forms of forest land ownership, as well as the basic features of State transfer taxes and the benefits of forest estate planning. The appendices include a glossary and the Federal forms for filing estate and gift taxes.

**Keywords:** Estate planning, estate tax, gift tax, insurance, special use valuation, transfer tax, trust.



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## **PART I**

### **INTRODUCTION**



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## Chapter 1

# The Importance of Forestry Estate Planning

### Forest Ownership

Forests comprise one-third of the Nation's land area. Nearly three-fifths of all forest land—430 million acres—is privately owned. More than four-fifths of privately owned forest land—363 million acres—belongs to nonindustrial owners.<sup>1</sup> Nonindustrial private forest owners are the individuals, families, and organizations which own forest land but do not operate primary wood-processing facilities; that is, they are not classified as forest industry. With the recent consolidation of forest industry ownership and industry's subsequent divestiture of much of its forest holdings, the proportion of forest land in nonindustrial private ownership is on the increase.

Forest land and timber values have risen rapidly in many parts of the country in the past decade; market values frequently reflect factors other than commercial timber production. The estate tax structure is in a state of flux, posing an ever-present danger for estates with substantial forest holdings. Without proper estate planning, forced liquidation of family forests or severe disruption of management regimes is a distinct possibility. Fragmentation of holdings and changing land uses can result.<sup>2</sup> Furthermore, the uncertainty created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), discussed in several of the following chapters, has frozen many forest land estate planning efforts. In many States, estate planning is further complicated by the recent decoupling of the State estate or inheritance taxes from the Federal estate tax, as discussed in chapter 18.

### A Diverse Group

Most nonindustrial private forest land in the United States is owned by individuals, married couples, family estates and trusts, or other informal family groups. Ownerships of this type number over 10 million and account for approximately 250 million forest acres. The remaining nonindustrial private acres are owned by more formal organizational entities,

including corporations, limited partnerships, and limited liability companies, many of which also are family-held. Nearly 90 percent of nonindustrial private forest ownerships are less than 50 acres in size. Well over half of nonindustrial private forest acres, however, are in holdings of 100 acres or more, and one-fifth are in holdings of 500 acres or more. The typical nonindustrial private forest owner is 60 years old.<sup>3</sup>

### What Can Happen?

If you own forest land and are approaching or in retirement, you may be asking yourself questions like: Can I afford to take early retirement, so I can work on projects on the tree farm I have always wanted to while I enjoy good health and vigor? How can I transfer the knowledge and experience gained from managing the land to my family? Are the wildlife plots, timber management practices, hiking trails, and cabin by the creek that I planned still feasible? If my spouse and I retire to the tree farm are the resources adequate that we can enjoy a satisfactory life style? How will retirement affect our timber investment income? Will sharing that income with our children serve to enrich and motivate them?

Going a step further, if you, your spouse, or both of you were to die today, what would happen to the forest land that you have worked together a lifetime to obtain? Do you have a forest management plan? If you do, will it continue to function as an effective tool for the survivors and provide for them in an equitable manner without disruption? Are your forestry investments structured so that they will retain their value at your death? Have you taken steps to minimize death taxes? Will timber or land or both have to be sold to pay family administrative expenses and estate taxes?

Examples abound of profitable forested estates that had to be partitioned or liquidated entirely to settle estate debts and pay death taxes following the owner's death. This is true especially in unplanned situations, and is exacerbated when the heirs quarrel over the terms of the estate settlement. Such complications tend to dissipate valuable forest resources.

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<sup>1</sup> Smith, W.B.; Miles, P.D.; Vissage, J.S.; Pugh, S.A. 2003. Forest resources of the United States, 2002. Gen. Tech. Rep. NC-241. St. Paul, MN: U.S. Department of Agriculture Forest Service, North Central Research Station. 137 p.

<sup>2</sup> Greene, J.L.; Bullard, S.H.; Cushing, T.L.; Beauvais, T. 2006. Effect of the Federal estate tax on nonindustrial private forest holdings. *Journal of Forestry*. 104(1): 15–20.

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<sup>3</sup> Butler, B.J.; Leatherberry, E.C. 2004. America's family forest owners. *Journal of Forestry*. 102(7): 4–14.

## The Purpose of This Book

The purpose of this book is to address the above issues. It is written to provide nonindustrial private forest owners and the legal, tax, financial, insurance, and forestry professionals who serve them a working knowledge of the Federal estate and gift tax law as it relates to estate planning for forest properties. The unique character of timber assets is addressed in terms of the estate planning goals of a forest owner. The purpose is to enhance, rather than replace, communication with estate advisors, and to make the planning process more efficient. In all cases, well-qualified professional advice is essential.

The discussion and examples presented in this book should be regarded as educational rather than legal or accounting advice. You should carefully review your own personal situation—family goals, financial portfolio, land and timber inventory, and specific considerations—with an attorney and estate planning advisor. The applicable laws and regulations, which often are complex, uncertain, and dynamic, must be applied to your specific situation and context before making legal and financial decisions. The book is written within the framework of Federal law, but an understanding of applicable State laws that affect the ownership, management and transfer of forest land assets also should be incorporated into estate planning deliberations. Because estate law varies widely among the 50 States and territories, much of it is beyond the scope of this publication. Nevertheless, State death tax laws and regulations must be considered even as the estate plan addresses the Federal statutes.

## Structure

This book is divided into four major parts, which are further divided into chapters. Part I develops the foundation for estate planning. Estate planning considerations and objectives, the planning process, and valuation principles are discussed, as well as the Federal estate and gift tax process, and the legal basis for estate planning.

Part II of the book explains general estate planning tools and illustrates their application to nonindustrial private forest land. Separate chapters discuss the use of the marital deduction, disclaimers, and strategies for gifting forestry assets. The role of trusts, life insurance, and installment contracts in estate planning also is addressed.

Part III introduces and explains forestry-specific estate planning tools, including special use valuation and deferral and extension of estate tax payments. The advanced planning and requirements necessary to qualify for and effectively utilize these tools is covered in detail using examples.

Part IV discusses the various forms of forest land ownership and their relationship to forest estate planning. Alternative business structures for timber estates, including the advantages and disadvantages of each, are discussed. Chapter 18 treats State transfer taxes, many of which now are decoupled from Federal law, and summarizes the basic features of the statutes in each State. Chapter 19 presents a comprehensive example of the financial benefit of planning a forest estate—or the cost of not planning.

The appendices include a glossary and selected Internal Revenue Service (IRS) tax forms and tables.

## Readiness Questionnaire

Effective estate planning is an ongoing process consisting of three major components. The first concerns effective management of the estate assets during the owner's lifetime. The second component, building on the first, is concerned with ensuring that the transfer of estate assets at death will be made in accordance with the owner's wishes, with a minimum of problems and minimum tax liability. The third component encompasses nontax situations that only can be addressed while living, through personal understanding of family circumstances and their interaction with effective planning. To better understand where you are in this process; take a few minutes to complete the Readiness Questionnaire on the following page (fig. 1.1).

**Check the appropriate blank to the left of each statement.**

Yes	No	
_____	_____	1. I have discussed the requirements for cash in the event of my spouse's death. I have knowledge of estimated Federal and State death taxes, as well as the debts and other costs payable at that time.
_____	_____	2. Specific plans exist to satisfy immediate financial needs in the event of my spouse's death.
_____	_____	3. I know what estate planning can accomplish, have set the objectives for my own estate plan and have discussed a plan for continued management of the family's timberland with family members.
_____	_____	4. Both my spouse and I have complete and up-to-date wills.
_____	_____	5. I understand the reason for probate and how it functions.
_____	_____	6. I know how to use trusts as an estate planning tool for saving taxes, lessening probate costs, and managing my assets.
_____	_____	7. My spouse and I know how to use the marital deduction for Federal estate tax saving in conjunction with the applicable credits.
_____	_____	8. I am aware of the tax savings available by using the gift provisions of the tax law, and the advantages and disadvantages of gifting versus testamentary transfers.
_____	_____	9. I understand the role of life insurance in my estate planning and how that role(?) changes over time.
_____	_____	10. I am aware of the details of my spouse's life insurance policies and know how to shelter policy proceeds from Federal estate tax.
_____	_____	11. I understand the different ways to hold timber property in my estate and the advantages and/or disadvantages of each.
_____	_____	12. I know how much family income will be received from retirement plans, social security, annuities, the family timberland, and other sources.
_____	_____	13. Both my spouse and I know how to contact our attorney, accountant, banking officer, life insurance agent, and forester. We both know where important documents are stored.

Figure 1.1—Estate planning readiness questionnaire.



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## Chapter 2

### Estate Planning Objectives and Considerations

#### The High Cost of Dying Unprepared

Do you have an estate plan? Perhaps surprisingly, the answer always is “Yes!” You can exercise your right to specify who will receive your various assets upon your death by preparing a will. If you fail to exercise that right, however, the State in which you are legally domiciled has a plan for disposing of your property. In fact, all States have laws of descent and distribution that apply to the estates of individuals who die intestate (without a will). The major exceptions to the laws are joint tenancies, where property passes to the surviving tenant, and life insurance contracts, where the proceeds pass to the named beneficiary. The State plans are general and fail to address a number of considerations. Simply put, they are rules that specify how the residue of an estate is to be divided once the “transfer costs” have been paid. Forest land is a unique asset and a poor fit for such a one-size-fits-all approach; almost always the State plans can be improved upon.

Do you have an estate plan? Perhaps surprisingly, the answer is “Yes”! Even if you have failed to exercise the privilege of expressing your desires by writing a will, the State in which you are legally domiciled has a plan for disposing of your property. In fact, all States have laws of descent and distribution for this purpose. If you have failed to exercise your right to specify who will receive your property at death, State law provides a general plan of rules that apply. The major exceptions are joint tenancies where property passes to the surviving tenant and life insurance contracts where the proceeds pass to the named beneficiary. Generally, the State’s plan can be improved because there are a number of considerations that it fails to address. Simply put, the rules are specific as to who gets the residue of the estate after the “transfer costs” have been paid

#### Unexpected Heirs

As noted above, all States have laws of descent and distribution that determine what happens to the property of a person who dies intestate. The surviving spouse, children, parents, siblings, and other relatives are considered in more or less that order. State law does vary in this regard, however, and becomes more complicated where blended second and third marriages are involved—especially where there are minor children. State statutes rarely consider the heirs’ needs, their contributions to the estate, or the tax consequences of the distribution.

#### Unexpected Values

The fair market value of appreciated real estate, closely held stock, jointly held property, and other interests with low current financial returns may greatly exceed the value attributable to such property from current cash flows. Fair market value often exceeds valuations based on the use value of the assets (see chapter 4 for a discussion of asset valuation for estate and gift purposes; see chapter 12 for a discussion of special use valuation). The Internal Revenue Service (IRS) focuses its estimates of value on the “highest and best use” of the property, preferring market transactions as evidence of value over other methods wherever possible. Consequently, the IRS valuations may be much higher than the value placed on estate assets in their current use by the executor. The demand for residential and recreational properties outside urban areas has driven up prices on forest land in many regions of the country. Heirs also may suffer from the hazards of unrealistic expectations from weak or worthless assets. Valuation is discussed in chapter 4.

#### Transfer Costs

Transfer costs include Federal and State death taxes, where applicable, and probate and estate administration expenses.

**Federal estate and State death taxes**—The Federal estate tax law encompasses taxable lifetime gifts combined with property passing at death in calculating the decedent’s tax liability. In 2008, during the transition under the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16), the Federal estate tax rate effectively is 45 percent on taxable estate values in excess of the \$2 million applicable exclusion amount (see tables 3.1 and 3.2). States with an estate or inheritance tax law may levy additional taxes that can amount to as much as 10 to 20 percent of the Federal estate tax. State death taxes are discussed in chapter 18.

Currently (2008), the annual exclusion of Federal gift tax law exempts \$12,000 per donee per year and \$1 million in lifetime taxable gift transfers over and above the annual exclusion per decedent. Thus, the Federal gift tax rate effectively begins at 41 percent on amounts over \$1 million and increases to 45 percent on amounts over \$1.5 million (see table 3.1; Federal estate and gift tax procedures are discussed in more detail in chapter 3). State gift tax laws are discussed in chapter 18.

**Probate and administrative expenses**—The cost of probate (discussed in chapter 5) and estate administration expenses comprise the other so-called “transfer costs.” Some States have adopted statutory limits for probate costs associated with small estates. Thresholds for applicable amounts under small estate laws vary from approximately \$5,000 to \$100,000. In estates exceeding this threshold, probate expenses may, in some cases, amount to as much as 8 or 9 percent of the value of the estate.

Generally, administrative expenses gradually fall as a percent of estate value as that value increases to \$1 million or more. On large estates, these charges may amount to 5 percent of estate value or lower if no problems are encountered. For example, on a \$2.5 million taxable estate the total average settlement costs (Federal estate tax, plus administration expenses equal to 5 percent of the estate) would be only \$350,000 in 2008 (table 2.1). This amount increases sharply to \$600,000 on a taxable estate of \$3 million.

**Loss of leadership and income**—The owner’s leadership and skill may be indispensable in successfully managing the forest land or timber business enterprise. Knowing boundary locations; having good relationships with neighbors, consultant foresters, loggers, and forestry vendors; having an understanding of silviculture; and having timber marketing experience all are part of a knowledge base built over a long period of time. At the owners’ death, this experience may be difficult or impossible to replace in the short run.

Nonindustrial forest owners typically are in an age group where they are near the peak of their earning power. At death these earnings could be sorely missed.

**Shrinkage because of liquidation**—When forest land or timber business assets have to be sold to pay taxes and administrative expenses or to retire indebtedness, the shrinkage losses can amount to a substantial portion of the estate. These losses can result from poor market timing, breakup of efficient working units, premature disposition of assets, and unfavorable financial arrangements. Partitioning of estate resources among the heirs also may have unfavorable consequences, both in terms of valuation and management efficiency. Such partitioning may be unavoidable due to differing objectives among the heirs.

**Ancillary probate**—Ancillary probate proceedings generally are required when real property is held in more than one State. The additional legal costs increase the estate’s overall administrative expenses. Certain legal forms and business organizational structures circumvent this situation, as discussed in part IV.

**Table 2.1—The high cost of dying—average settlement costs at death based on Federal estate tax in 2008, plus an average administration cost of 5 percent**

Taxable estate	Federal estate tax	Administration expenses	Total settlement costs
<i>dollars</i>			
100,000	0	5,000	5,000
200,000	0	10,000	10,000
300,000	0	15,000	15,000
400,000	0	20,000	20,000
500,000	0	25,000	25,000
600,000	0	30,000	30,000
700,000	0	35,000	35,000
800,000	0	40,000	40,000
900,000	0	45,000	45,000
1,000,000	0	50,000	50,000
1,250,000	0	62,500	62,500
1,500,000	0	75,000	75,000
1,750,000	0	87,500	87,500
2,000,000	0	100,000	100,000
2,250,000	112,500	112,500	225,000
2,500,000	225,000	125,000	350,000
3,000,000	450,000	150,000	600,000
3,500,000	675,000	175,000	850,000
4,000,000	900,000	200,000	1,100,000
5,000,000	1,350,000	250,000	1,600,000
6,000,000	1,800,000	300,000	2,100,000
7,000,000	2,250,000	350,000	2,600,000
8,000,000	2,700,000	400,000	3,100,000
9,000,000	3,150,000	450,000	3,600,000
10,000,000	3,600,000	500,000	4,100,000

## Estate Planning Considerations Particular to Forestry

Estates with substantial forest land and timber values often have many of the problems described above. They also have many additional considerations that arise from the unique nature of the forest land asset and the economic climate in which the forest owner operates. The financial returns on timber investments are driven by three primary factors: timber growth (site productivity), timber markets (stumpage price), and the cost of capital (interest rates). Landowner investment and harvest decisions interact in complex ways with these factors, which in turn are influenced by Federal and State tax considerations.



## Illiquidity of Land and Timber Assets

Land “dedicated” to timber production is characterized by a long investment horizon. Timely and appropriate management decisions are important in order to establish and maintain the desired level of timber growing stock to achieve its earning potential. This limits the potential number of buyers in the market for timbered assets and requires skill, timing, and luck to obtain top market values when transferring timber properties. In addition, timber prices are volatile and follow long and often irregular price cycles.

## Low, Irregular Income

**Low income**—Low or inadequate returns on forest assets often result from premature harvesting, over-cutting, and under-investing in reforestation and maintenance of timber growing stock. Under these circumstances, the potential returns from the forest land fail to be realized.

**Irregular income**—Ideally, the age classes of timber stands are distributed so that a more or less even flow of timber volume and revenue results. On most private forests, however, timber income is irregular because of past land use practices. As noted above, under-investment also contributes to an uneven flow of income. The average tenure of nonindustrial forest land holdings is approximately 10 years, while timber rotations may vary from 25 to 50 or more years. In addition, the average owner is 60 years of age. The combination of owner age and relatively short tenure suggests that sporadic cash flows will be the usual case. Even in all-aged stands, excess cutting or high-grading (cutting the best trees without regard for the future stand) will invariably disturb the cutting schedule and contribute to irregular income.

## Continuity of Management

Continuous long-term sustainable management under a well-defined set of goals is the most effective way to ensure efficient timber production from forest holdings. This goal clearly is desirable from a societal point of view. From an owner’s perspective, its primary importance is in keeping timber assets productive. For all its public and private benefits, however, continuity of management often is at variance with an owner’s immediate goals and personal situation. Many variables affect an owner’s management and harvest decisions, and some may interrupt the continuity of management associated with an optimum financial return. As noted above, the average tenure of nonindustrial private forest landowners is a relatively short 10 years. Even with larger holdings that have longer average tenure, the holding period rarely approaches a typical rotation cycle of 25 to 40 years in the South, and longer in the North and West.

Within these short time frames, Federal tax laws further complicate the intergenerational transfer of forest property, contributing to the liquidation of growing stock and disrupting management continuity. Partitioning the estate often produces similar results. Careful planning is required to ensure continuity of management and the attendant benefits.

## Unitary Nature of the Forest

Economies of scale in management, harvesting, and reforestation generally are achieved only on holdings of perhaps 1,000 acres or more. The exact size will depend on site quality, species mix, markets, and other variables. There is a rather well-defined inverse relationship between tract size and the unit cost of production; that is, as forest land size increases the cost per acre of reforestation, harvesting, and management operations decreases.

An even flow of timber and other outputs can be achieved only on holdings large enough to have a diversity of timber stands, age classes, and species. For example, if one assumes a 40-year rotation, defines the minimum operable stand size as 20 acres for cultural treatments, and wants income every 5 years, a 160-acre  $[(40 \text{ years} \div 5 \text{ years}) \times 20 \text{ acres}]$  minimum of operable land stocked with age classes at 5-year intervals is required. If annual income is desired, an 800-acre minimum (40 years  $\times$  20 acres) is necessary (assuming clear-cut management with no thinning). The problem, however, is that age classes are rarely uniformly distributed, and the distributions that do exist are upset as family changes or estate proceedings require liquidation to raise cash. A management plan can help to solve some of these difficulties.

Fragmentation of forest land holdings is encouraged by real estate markets and estate tax policies. Consider a 1,000-acre forest property with four parcels of approximately equal size, which have age classes that differ by 10 years per parcel. In the aggregate, an even flow of income and low-cost management is possible. At the owner’s death, however, one parcel each passes to the surviving spouse and three children (the values are equalized internally to account for the different levels of growing stock on each parcel). In the absence of a family agreement to the contrary, the death will disrupt the flow of timber income, and the cost of management operation will increase. A forest management plan will not prevent this outcome if the respective parties do not reach an agreement that encompasses continuity of management for the entire acreage.

**Example 2.1.** Consider the 1,000-acre property noted above, which is composed of four parcels of approximately equal size. A forest management plan will include an inventory of the timber stands by

species, age, volume, and condition. An operational plan will project and treat each stand based on the owner's goals (including the estate plan, if desired). The options for a 40-year rotation (investment period from seed to harvest) are illustrated by the cutting cycle: (1) harvest 25 acres per year from mature timber for an even flow of wood products; (2) harvest 250 acres in every 10-year period when the highest prices are expected; (3) harvest the growth from all merchantable timber on a 5-year cutting cycle; (4) cut timber when the family needs money; or (5) any combination of the above. The plan will depend on the timber market, the family's needs for income, and the biological condition of the forest. A forester can transform the timber inventory into the most effective operational plan to meet the owner's goals and to utilize the maximum potential of the forest. A forest management plan is discussed in more detail below.

### **Difficulty in Obtaining Credit**

Forests are unimproved real estate and largely unproductive in the premerchantable and young growth stages of a rotation. A forest landowner, typically 60 years or more of age, with standing in the community and forestry experience, should have excellent credit. In contrast, it may be more difficult initially for a surviving spouse to obtain credit if he (she) does not have an established credit record. It may be even more difficult for the children, depending on their age and maturity. The loss of income and family leadership exacerbates the problem of credit worthiness when coupled with liquidity needs of the family to cope with estate transfer costs. This is an important issue to address in the planning process.

### **A Forest Management Plan as Part of the Estate Plan**

The primary goal of estate planning is the accumulation and conservation of wealth, including its transfer to heirs and other beneficiaries. With respect to forest land in the estate, a forest management plan is essential to both the goal of producing income and that of preserving the land's inherent productivity through sustainable management.

The management plan may address several goals such as income, wildlife management, and value appreciation. It should have both strategic and operational dimensions. The strategic plan focuses on long-term goals such as optimizing the rotation length or structuring the age-class distribution of timber growing stock to produce an even flow of income. The operational plan focuses on the production of net income over a relatively short period, typically 5 years.

The first step in building an operational plan is to obtain a current inventory with stand-level detail. All forestry operations during this period, including wildlife activities, together with their related costs and revenues are scheduled. For the revenues, mature stands are analyzed for rate of return and income to be generated. Financial decision rules are developed to guide the replacement of less productive stands by harvesting them. Similarly, the expected returns for reforestation, timber stand improvements, and other projects are analyzed and the decision rules used to choose the most productive use of limited investment capital. Once the operational plan is in place, an annual budget targets the specific stands to be harvested and details plans for reforestation and other silvicultural activities. These plans are completed in the context of the owner's objectives and the prevailing market environment.

A good operational plan has the flexibility to make adjustments: (1) in revenues as owners' needs and/or market conditions fluctuate; (2) in expenditures as liquidity and the cost of capital vary; and (3) in either or both as unexpected external factors such as shifts in public policies or casualty losses occur.

The short-term operational plan functions within the context of the strategic plan, which is developed to meet the long-term management goals for the forest land. Species selection, stocking levels, and rotations are addressed in the strategic plan, as well as the interaction among the various timbers, wildlife, and other goals. At the operational level, however, each stand functions as an individual investment from which thinning and final harvest revenues are projected. Similarly, annual management expenses for property taxes, timber stand maintenance, competition control, and growing stock enhancements such as fertilizer are prescribed. These are inputs for making management decisions on stocking control and property maintenance.

The scope and sophistication necessary to develop a forest management plan depend on the individual owner's circumstances. For a small property with modest timber value, the owner may be able to achieve his (her) forest land objectives with a relatively simple plan. As property size and timber value increase, however, more attention should be devoted to the plan, reflecting the greater investment in the resource and its potential earning capacity.

### **Specific Estate Planning Objectives**

Although it may be difficult for family members to agree on the planning objectives for the estate and its forest property, reaching agreement is necessary for development of the estate plan. Conflicts often arise when estate plans have multiple objectives, and must be resolved before progress on the plan can be made. Rarely is it possible to satisfy all

objectives completely, so priorities have to be established for allocating the two primary estate resources—income and property.

Timing, equity, organization, and tax strategies are among the more common considerations to be addressed in the planning process. Timing addresses the choices between current and future consumption (i.e., enjoyment in this generation or the next). Equity deals with the shares of inheritance among the heirs, special needs of certain family members, and the contribution of various family members to building the estate. The form of ownership or business organization often must be decided in terms of who will be in control and whose philosophy of management will prevail. Tax-saving strategies must be integrated with the other goals in a way that retains a balanced plan. In some instances, maximum tax savings may be sacrificed in order to realize a goal in another area. Finally, there is the element of trust. If members of the immediate family and any in-laws cannot respect and trust one another, the planning effort becomes much more difficult.

### **Preretirement and Postretirement Security**

It is essential that adequate resources be allocated for the financial security and well-being of the estate owner(s) before and during retirement. Involvement in management activities and professional interests may be important in retirement. Planning for continuity of business activities is discussed below.

### **Security and Compassion for Family Members**

The financial security, comfort, and happiness of the surviving spouse, either husband or wife, should be the highest priority for most estate plans. The ability of the survivor to care for the children, manage daily affairs, and deal with grief due to the decedent's death must be considered. With most estates, the husband and wife have worked together for many years to accumulate the estate assets, often at considerable sacrifice. The death of either spouse usually is followed by a period of adjustment with respect to both personal and business affairs. The survivor's comfort and happiness during this time will depend greatly on the amount and types of assets received from the estate, and on the control the survivor has over his (her) resources.

In some cases, State law provides for the surviving spouse to have certain minimum rights in the real and personal property "solely owned" by the deceased spouse, regardless of what may be stipulated in a will. The further implications of property ownership are developed in part IV. Proper estate planning can help to ensure that the amount left to the survivor at the death of either spouse will be adequate.

Specific adjustment can then be made, if necessary, by means of a will—subject to State law. Wills are discussed in more detail in chapter 5.

### **Equitable Treatment of Children**

State laws of descent and distribution generally provide for equal distribution of property among children. Although equal distribution is desirable in principle, it may not address important differences in the children's situations or contributions to the family. Differences to consider include: (1) a large investment in a particular child's education; (2) an extra investment in one child's business or purchase of a home; (3) a large contribution from a child to the parents in money or in kind; (4) care for children with physical or mental disabilities; and (5) the children's differing contributions toward managing the forest land. Equitable adjustments for these types of situations can be addressed by a will or by other planning techniques. A realistic assessment of the working relationships among children and in-laws is essential. In the absence of a will, State law will control the distribution of the decedent's property.

### **Continuity of the Forest Enterprise**

The time required to settle an estate can vary from a few months to several years, depending on the complexity of the settlement. Plans should be made for continuity of management of the forest land, or assets and opportunities can quickly disappear. It is essential to take advantage of favorable timber markets within the context of the forest management plan and to make timely investments in reforestation and cultural practices that keep the assets productive. Protection from timber trespass, theft, and natural hazards (insects, diseases, and wildfire) also is important. Proper estate planning can ensure that an operational forest management plan continues after the death of the decedent. The will or other instrument should direct that business operations of the estate continue during this critical transition period.

### **Minimize Transfer Costs**

Generally, one of the principal goals of estate planning is to minimize the impact of transfer costs at death. As discussed above, transfer costs include Federal and State death taxes, probate expenses, and the costs of administering the estate.

**Minimizing tax liabilities**—Careful attention to the tax consequences of property disposals is required. Gifts made during the decedent's lifetime may be subject to gift taxes (see chapter 9 for a discussion of the advantages and disadvantages of gifts). Property given to the spouse during the decedent's life or at death is shielded from tax by the marital deduction; however, this only defers the ultimate

payment of the tax (see chapters 6 and 19 for discussion of the tax effects of the marital deduction). State death taxes, which vary greatly from one State to another, also must be considered (see chapter 18). Careful planning is required to minimize taxes without jeopardizing other objectives. The husband and wife must make a fundamental choice in estate planning: (1) minimize taxes at both deaths and pass the maximum value to the children, or (2) minimize taxes and other costs at the death of the first spouse, leaving the surviving spouse with the maximum possible wealth and control over estate assets. The latter approach will ultimately cost the children more in estate taxes and administrative costs.

**Minimizing administrative costs**—Certain steps can be taken to reduce administrative costs, and even to avoid probate, but at the cost of flexibility and perhaps additional taxes. Because all choices have advantages and disadvantages, they should be carefully considered in terms of overall objectives.

### **Provide Flexibility and Durability**

There always are tradeoffs in saving estate taxes. Rigid plans rarely work well over long periods of time because of changes in the family, the law, and the economy. It generally is best to choose an executor who can be trusted to make decisions that benefit all concerned to the maximum extent possible and to provide him (her) the flexibility to do so. When it is necessary to protect the interests of a specific heir, however, the desired outcome should take precedence over flexibility.

## **Estate Planning Team for Forest Landowners**

### **Forest Landowner**

The role of the forest landowner on the estate planning team is to set the overall objectives for the estate plan and ensure they are met in a cost-effective manner. Owners who relinquish this role to other team members run the risk of ending up with a plan that meets objectives other than their own. As noted above, developing the objectives is best done in discussion with the other members of the family.

Consultations with professional advisors should be preceded by a personal fact-finding process that includes an analysis of the family situation and takes into account current and projected lifestyle desires and financial needs. The fact-finding process also should include an inventory comprising the description, form of ownership and value of all estate assets. Legal descriptions of all real property, locations of deeds and other important documents, and all indebtedness

should be listed. Values for all assets should be projected for the next 5 years. The forest management plan will provide the basis for timber volume and value projections. Additionally, insurance policies, beneficiary designations, and policy options should be reviewed.

### **Attorney**

The family attorney usually has the primary responsibility for coordinating the estate planning process. If he (she) lacks sufficient knowledge of the Federal and State tax laws governing the transfer of real and personal estate assets, an attorney specializing in estate planning should be engaged. When particular complications exist or difficulties in the business operations warrant, expert help is well advised. The attorney articulates the owner's objectives to the other team members, supervises the inventory of personal data and estate assets, and works with other professionals to evaluate alternative estate planning strategies. The attorney drafts the will and other legal documents that are required to execute the completed estate plan, including the supervision of changes in property titles and insurance beneficiaries to conform to the plan.

### **Certified Public Accountant (CPA)**

A CPA understands the complex interplay among the estate, gift, and income tax laws and prepares and files the appropriate tax returns and other tax documents. Because he (she) typically has access to the client's financial and tax records, the CPA can discuss appropriate estate-planning opportunities.

### **Institutional Trust Officer**

An institutional trust officer, who may be both lender and corporate trustee, often has an awareness of the financial needs of the estate. As a banker, he (she) can help explain the financial and tax aspects of alternative planning choices, and has expertise in the trust department that can be used during the decedent's lifetime and later by the survivors. A trust officer also has knowledge of how various types of trusts can help meet specific estate planning objectives. The role of trusts in estate planning is covered in chapter 9.

### **Chartered Life Underwriter (CLU)**

A CLU can develop an insurance program that will provide the kind and amount of insurance required to meet the estate's estimated financial needs. The purchase of life insurance can provide the liquidity necessary to cover the estate's transfer costs, ensure protection of estate assets, and build estate assets at critical times. In some States, insurance consultants offer professional estate planning evaluations for a fee that is dependent only on the service

provided rather than on the sale of a particular insurance package. The recommended insurance coverage can then be purchased from the company of choice, with consideration being given to price as well as to the company's strength and rating. This approach avoids any appearance of a conflict of interest when dealing with an insurance broker. The role of insurance in estate planning is covered in chapter 10.

### **Forester**

A forester is a nontraditional member of an estate planning team; nevertheless, he (she) can provide an invaluable service if there are substantial forest assets in the estate. A forester can prepare a forest management plan that specifically addresses estate-planning goals and functions as an integral part of the overall estate plan. A forester routinely brings management, marketing, and harvesting skills to the planning process, and often has knowledge of forest taxation issues and how they interact with other estate considerations.





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## Chapter 3

### The Federal Estate and Gift Tax Process

#### Background

The Federal government has levied a tax—the estate tax—on the transfer of a decedent’s estate since 1916; it has imposed a tax—the gift tax —on the inter vivos (lifetime) transfer of property by individuals since 1932. Over the years, the two taxes have undergone many changes. Prior to 1977, they were independent of one another. Since that year, however, they have been companion taxes that must be considered together in the context of estate planning.

#### Unified Rates and Credit

Federal estate and gift tax rates were unified into one rate schedule by the Tax Reform Act of 1976 (TRA; Public Law 94-455). The rate brackets for both gifts and estates became identical at that time. TRA also established a unified estate and gift tax credit to offset taxes owed. Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; Public Law 107-16), however, brought significant changes to these aspects of the Federal transfer tax system. In order to comply with the Congressional Budget and Impoundment Control Act of 1974 (Public Law 93-344), EGTRRA was written so that all provisions and amendments made by it will “sunset” after December 31, 2010. Unless Congress acts affirmatively in the interim, the Internal Revenue Code (IRC) will, thereafter, be applied and administered as if these provisions had not been enacted. This means that under current law, the discussions in the following paragraphs will apply only to the estates of decedents dying, or gifts made, before January 1, 2011.

#### Unified Rates

As shown in table 3.1, the rate brackets in the unified rate schedule in 2008 range from a low of 18 percent to a high of 45 percent for amounts in excess of \$1.5 million. An additional 5-percent surtax, which had been applied to a portion of transfers in excess of \$10 million, but less than \$17,184,000, has been repealed with respect to decedents dying, and gifts made, after December 31, 2001.

#### Applicable Credit Amount

Since the enactment of EGTRRA, the unified credit has been referred to as the applicable credit amount. In effect, the unified credit has been “de-unified” in that different

schedules of applicable exclusion amounts sheltered by an applicable credit now apply to the estate tax and the gift tax. Thus the computation of the applicable credit amount for estate tax purposes is different from that for gift tax purposes.

As shown in table 3.2, the estate tax applicable exclusion amount was \$1 million for 2002 and 2003; for 2004 and 2005 it was \$1.5 million; for 2006, 2007 and 2008 it is \$2 million; for 2009 it will be \$3.5 million. Because of the applicable exclusion, the effective estate tax rate from 2007 through 2009 is 45 percent.

EGTRRA also set the applicable exclusion amount for the gift tax at \$1 million for 2002. Unlike the gradual increase in the estate tax applicable exclusion amount in the years leading up to 2010, however, the gift tax amount remains at \$1 million and is not indexed for inflation. Thus the effective gift tax rates from 2007 through 2009 range from 41 to 45 percent.

The use of the applicable credit amount begins with taxable gifts made during the decedent’s lifetime. It is mandatory that the credit be applied to such gifts; no tax actually is paid on a taxable gift until the \$1 million credit is completely used up. Thus, some or all of the credit may be exhausted during a decedent’s lifetime and not be available for use by his (her) estate.

Gifts are discussed in greater detail in chapter 8, including what does and does not constitute a taxable gift.

#### Determination of Gross and Taxable Estate

##### Gross Estate

The gross estate is defined as the value of all property—both real and personal and tangible and intangible—owned by the decedent on the date of death, or in which he (she) had an ownership interest on the date of death. Thus, the first step in the estate settlement process is a complete inventory of the estate assets.

**Table 3.1—Federal unified estate and gift tax rate schedule, through 2009**

Amount on which tax is computed	Tentative tax
Not over \$10,000	18 percent of such amount
Over \$10,000 but not over \$20,000	\$1,800, plus 20% of amount over \$10,000
Over \$20,000 but not over \$40,000	\$3,800, plus 22% of amount over \$20,000
Over \$40,000 but not over \$60,000	\$8,200, plus 24% of amount over \$40,000
Over \$60,000 but not over \$80,000	\$13,000, plus 26% of amount over \$60,000
Over \$80,000 but not over \$100,000	\$18,200, plus 28% of amount over \$80,000
Over \$100,000 but not over \$150,000	\$23,800, plus 30% of amount over \$100,000
Over \$150,000 but not over \$250,000	\$38,800, plus 32% of amount over \$150,000
Over \$250,000 but not over \$500,000	\$70,800, plus 34% of amount over \$250,000
Over \$500,000 but not over \$750,000	\$155,800, plus 37% of amount over \$500,000
Over \$750,000 but not over \$1,000,000	\$248,300, plus 39% of amount over \$750,000
Over \$1,000,000 but not over \$1,250,000	\$345,800, plus 41% of amount over \$1,000,000
Over \$1,250,000 but not over \$1,500,000	\$448,300, plus 43% of amount over \$1,250,000
Over \$1,500,000	\$555,800, plus 45% of amount over \$1,500,000

**Table 3.2—Estate tax applicable credit and exclusion amounts**

Year	Applicable credit	Applicable exclusion
	<i>dollars</i>	
1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000 and 2001	220,550	675,000
2002 and 2003	345,800	1,000,000
2004 and 2005	555,800	1,500,000
2006 through 2008	780,800	2,000,000
2009	1,455,800	3,500,000
2010	Estate tax repealed	



## Valuation

Once property interests have been established, they must be valued. Valuation of both timber and nontimber assets is discussed in detail in chapter 4. The general rule, however, is that property, comprising the gross estate, must be valued at fair market value; either as of the date of death or as of the alternate valuation date. Special use valuation, in lieu of fair market value, also is possible for forest property and certain other types of estate assets, as discussed extensively in chapter 12. Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all of the relevant facts.

The estate assets may be valued as of the date falling 6 months after the decedent's death (alternate valuation date) if two tests are met: (1) alternate valuation decreases the value of the gross estate, and (2) it results in a decrease in the net Federal estate tax payable. The alternate valuation election must be made on the first estate tax return filed. Once elected, it applies to all property in the gross estate; the executor may not alternately value some assets and not others. A valid alternate valuation election may be made on a late-filed return, as long as it is filed no later than 1 year after its due date. The election also is irrevocable—at least after the due date for filing has expired.

## Taxable Estate

The definition of taxable estate is the value of the gross estate, less all permitted deductions. There currently (2008) are seven permitted deductions: (1) funeral and related expenses for the decedent, (2) estate administration expenses, (3) debts of the decedent, (4) casualty and theft losses occurring during estate administration, (5) State death taxes paid, (6) the charitable deduction, and (7) the marital deduction. The deduction for State death taxes became effective in 2005, replacing the State death tax credit, which was phased out between 2002 and 2004. The qualified family business deduction was available to qualified estates through 2003 but was repealed by EGTRRA for decedents dying in 2004 or later.

**Funeral expenses**—These include the costs of interment, the burial lot or vault, grave marker, future care of the grave site, and transportation to bring the body to the burial place. Funeral expenses must be reduced by any reimbursement from the U.S. Department of Veterans Affairs for funeral expenses and any funeral expense benefit payable to other than the decedent's spouse by the Social Security Administration. The Internal Revenue Service (IRS) takes the position that, if a decedent's estate is not primarily liable for payment of funeral expenses, no deduction is allowed for

Federal estate tax purposes unless the decedent's will directs that the funeral expenses be paid out of the decedent's estate.

**Administration expenses**—These include costs incurred for collection, storage, and preservation of estate property; payment of estate debts; distribution of estate property; executor fees; attorney fees; and tax preparation fees, among others. The IRS considers only those administration expenses “actually and necessarily” incurred for such purposes to be deductible.

**Debts**—These are personal obligations of the decedent that existed at the time of death, including interest accrued to the date of death. They include such obligations as mortgages, liens, unpaid income taxes on income includable on a return of the decedent for the period prior to his (her) death, unpaid gift taxes, unpaid property taxes accrued prior to death, and unpaid medical expenses as of the date of death. Medical expenses incurred by the decedent that are paid within 1 year of death may be deducted either on the estate tax return or on the decedent's final income tax return. The IRS generally does not allow the deduction of interest accruing after death on debts incurred prior to death. The courts, however, have not always followed the IRS position; several have allowed such interest to be deducted if reasonable and necessary for administration of the estate.

**Casualty and theft losses**—These may be deducted if they occur during estate settlement and prior to distribution of the asset in question to the heir or legatee. The deduction is reduced to the extent that the loss is offset by insurance or other compensation and to the extent that it is reflected in alternate valuation if such valuation is elected. A casualty or theft loss may be deducted on either the estate tax return or the estate's income tax return—but not on both.

A deductible loss must be one with respect to tangible property. Depreciation in value of intangibles, even though occasioned by destruction, damage, or theft of underlying physical assets, is not deductible. Losses in value of intangibles can serve to reduce the taxable estate, but only if they occur within 6 months after death so that the intangibles may be included in the estate at their value as of the alternate valuation date.

**State death taxes**—Under current law the deduction for State death taxes paid will remain in place through 2009 until the repeal of the estate tax in 2010.

**Charitable deduction**—A deduction is allowed for estate assets that are transferred by the decedent's will to specified public or charitable entities or uses. These include the units of Federal and State government; units of local government if the transferred assets are used exclusively for public purposes; religious, charitable, scientific, literary,

or educational organizations; fraternal societies (for gifts used exclusively for religious, charitable, scientific, literary, or educational purposes); and veterans' organizations incorporated by an act of Congress. There is no limitation on the amount of the charitable deduction, but it cannot exceed the net value of the property that passes to charity as reflected in the gross estate.

**Marital deduction**—The value of certain property interests that pass from the decedent to his (her) surviving spouse can be deducted from the decedent's gross estate. Generally, in the case of simultaneous death, local law governs as to a presumption of who was the first to die.

### Determination of Tax Due

The next step is to compute the tentative tax on the sum of the taxable estate, plus adjusted taxable gifts. Adjusted taxable gifts are defined as the total amount of taxable gifts made by the decedent after December 31, 1976, other than those gifts that must be included in the gross estate. Lifetime gifts that must be included in the gross estate for one reason or another are discussed in chapter 8. The current unified rate schedule is then applied to this cumulative total (sometimes referred to as the "estate tax base") comprised of transfers both during life and at death. The result is the tentative estate tax.

Once the tentative tax is determined, it is reduced by the gift taxes (those previously paid, plus those not yet paid) on gifts made after December 31, 1976. The result is the gross estate tax. The tax payable on a post-1976 lifetime gift is the amount owed on that gift after the gift tax otherwise payable is reduced by the unified credit or applicable credit amount. The estate tax reduction for gift taxes paid on such gifts is based on the rate schedule in effect on the date of death, not on the schedule in effect at the time of the gift, if the two are different.

### Credit Reductions

Once the gross estate tax is determined, it is reduced by certain credits to determine the net estate tax due. There are four such credits: (1) the unified credit (applicable credit amount) discussed above; (2) the credit for Federal gift taxes paid on certain pre-1977 transfers; (3) the foreign death tax credit; and (4) the credit for Federal estate taxes on prior transfers.

**Applicable credit amount**—The amount of the applicable credit amount available at the decedent's death (\$780,800 in 2008, minus any of the credit applied to lifetime gifts) will be reduced if the decedent made a taxable gift at any time after September 8, 1976, and before January 1, 1977. Prior to unification of estate and gift taxes in 1977,

a specific lifetime gift exemption of \$30,000 was permitted. The applicable credit amount must be reduced by 20 percent of the exemption allowed for a gift made during this period. For example, if the decedent had made a gift on October 15, 1976, and used the entire lifetime exemption of \$30,000, the applicable credit amount would be reduced by \$6,000 (20 percent of \$30,000).

**Credit for taxes on pre-1977 gifts**—A credit is allowed for gift taxes paid on pre-1977 gifts that must be included in the donor's gross estate under any provision of law that mandates such inclusion. These provisions are discussed in detail in chapter 8. The credit is limited to the lesser of: (1) the gift tax paid on the gift that is included in the gross estate, or (2) the amount of estate tax attributable to the inclusion of the gift in the gross estate.

**Foreign death tax credit**—A credit is allowed for foreign death taxes paid with respect to property in the decedent's estate if the property actually is situated in a foreign country. The credit is the lesser of the foreign death tax or the Federal estate tax attributable to the property.

**Credit for estate taxes on prior transfers**—A credit is allowed for all or part of the Federal estate tax paid on transfers to the present decedent of property from a transferor who died within 10 years before or 2 years after the present decedent's death. The credit is the smaller of (1) the amount of the Federal estate tax attributable to the transferred property in the prior decedent's estate, or (2) the amount of the Federal estate tax attributable to the transferred property in the present decedent's estate. If the transferor dies within 2 years before or 2 years after the present decedent's death, the full credit is allowed. If the transferor dies more than 2 years before the present decedent, the credit is reduced by 20 percent for each full 2-year period by which the death of the transferor preceded the death of the present decedent.

### Estate Tax Computation

**Example 3.1.** Assume that the decedent died in 2008 with a gross estate valued at \$2.9 million. In 2005 the decedent had made a taxable lifetime gift of property valued at \$1.1 million to his daughter. He had filed a gift tax return and, after deducting the applicable credit amount available in 2005, paid a net gift tax of \$41,000 (tentative gift tax of \$386,800, minus \$345,800 credit). There were no other lifetime taxable gifts.

The decedent's gross estate of \$2.9 million includes the gift tax of \$41,000 that was paid but not the value of the gift itself. Because the entire gift was taxable and is not included in the gross estate, it is added to the taxable estate to determine the tentative tax, as discussed above. The net estate tax is computed as follows:

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Gross estate	\$ 2,900,000
Minus debts and administrative expenses	<u>150,000</u>
Taxable estate	2,750,000
Plus adjusted taxable gifts	<u>1,100,000</u>
Taxable amount	3,850,000
Tentative tax [\$555,800 + 45 percent x (\$3,850,000 – \$1,500,000)]	1,613,300
Minus gift tax paid	<u>41,000</u>
Gross estate tax	1,572,300
Minus applicable credit amount	780,800
Net estate tax due	<u>\$ 791,500</u>



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## Chapter 4

# Valuation of Assets for Estate and Gift Purposes

### General Considerations

The Federal estate and gift taxes, as discussed in chapter 3, are excise taxes that generally are levied on the fair market value (FMV) of property that is gratuitously transferred. Special use valuation for estate tax purposes is an exception to the FMV rule; the applicability of special use valuation to forest properties is discussed at length in chapter 12.

Treasury Regulation 20.2031-1(b) defines FMV as:

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

Valuation of estate and gift assets is thus a critical component of estate planning. In arriving at the taxable base on the date of transfer, FMV is determined on the basis of “highest and best use” rather than on the use to which the property actually is being put at the time of the transfer. Although the two uses may be the same, often they are not.

Establishment of FMV for estate and gift assets sometimes is an elusive process. The estate planner and his (her) advisors must therefore anticipate possible disagreements over valuations of some types of property. If the value of an item on the estate tax return is challenged, the law permits the executor to require the Internal Revenue Service (IRS) to furnish, within 45 days of the request, a statement indicating: (1) the basis for the IRS’s conflicting valuation; (2) any computations used in arriving at the IRS value; and (3) a copy of any expert appraisal made for the IRS. The same rule applies to gift valuations. The request must be filed by the deadline for claiming a refund of the tax that is dependent on the valuation.

### Undervaluation

An accuracy-related penalty may be imposed with respect to any portion of an underpayment that is attributable, among other factors, to negligence or disregard of rules and regulations, or any substantial understatement of valuation on a Federal estate or gift tax return. The penalty is equal to 20 percent of the portion of the understatement. A substantial estate or gift tax understatement exists if the value of any property claimed on a return is 50 percent or less of the amount determined to be the correct

valuation. No penalty is imposed for a substantial valuation understatement unless the portion of the underpayment attributable to substantial undervaluation exceeds \$5,000.

The penalty is increased to 40 percent for gross valuation understatements. A gross valuation understatement occurs if the value of any property claimed on a return is 25 percent or less of the amount determined to be correct. An accuracy-related penalty generally will not be imposed on that portion of an understatement for which the taxpayer shows there was reasonable cause for the underpayment and that he (she) acted in good faith with respect to the valuation.

### State Death Tax Considerations

In some cases, undervaluation could be detrimental from an income tax standpoint, particularly for forested properties in situations where no Federal estate tax return is required. Under current law all such estate property, including timber, receives a “stepped-up” basis for income tax purposes equal to its valuation on the State death tax return (or as of the date of death if no State return is required). If a State death tax is levied, its marginal rate virtually always will be less than the combined Federal and State marginal income tax rates that would apply if the timber is subsequently sold—either by the estate itself or by those who inherit it. Undervaluation of timber on the State death tax return, therefore, will mean a higher income tax bill upon sale of the timber than would otherwise be the case. In almost all such situations, the additional income tax will far exceed the State death tax savings resulting from the low valuation. State death taxes are discussed in chapter 18.

### Special Considerations

#### Discounting for Minority and Undivided Interests

There is no authority for discounting fractional interests in either the Internal Revenue Code (IRC) or in the regulations, except the statement in Treasury Regulation 20.2031-1(b) that “all relevant facts and elements of value as of the applicable valuation date shall be considered in every case.” Nevertheless, an undivided fee ownership interest in forest land—particularly if it is a minority ownership interest—typically is discounted below its fractional proportion of the value of the tract as a whole. Minority interests in closely

held timber-owning corporations and partnerships are discounted similarly. Other situations that may contribute to discounting are lack of marketability of the ownership interest, transfer restrictions, expenses of partition suits, and combinations of these factors.

**Expert testimony**—Determining the amount of the discount generally is more art than science. In most disagreements with the IRS, heavy reliance is placed on expert testimony. Among the factors typically addressed by expert witnesses are the following: (1) the difficulties faced by owners of fractional interests in securing purchasers except at substantial discounts; (2) the limits placed on owners of fractional interests with respect to control, management, and operation of the property; (3) the inconvenience of dealing with multiple owners; (4) the possibility of complications caused by owners of very small fractions; and (5) the danger of partition suits.

The applicability of discounting to corporate stock and partnership interests is discussed in more detail in the subsequent sections that address the valuation of these two specific types of assets.

### Life Insurance

The value of a gift of life insurance is equal to the cost of replacing the policy on the date of the gift. This applies whether the policy is on the donor's life or on the life of a person other than the donor. The value may be obtained by the donor from the insurance company.

The value of a life insurance policy owned by a decedent on the life of a person other than the decedent generally is the amount the insurance company would charge for a comparable policy on the date of the decedent's death. In contrast, an insurance policy on the life of the decedent that is owned by the decedent has a value equal to the proceeds payable by the policy. Chapter 10 discusses in more detail when life insurance policies and proceeds are includable in an estate and when they are not.

### Future Interests

The term "future interests" refers to certain interests taken by a donee or legatee. These are interests, whether vested or contingent, that are "limited to commence in use, possession, or enjoyment at some future date or time" (Treasury Regulation 25.2503-3). The value of property transferred by a gift which becomes effective at the donor's death, or at some other future time, is determined by reference to government valuation tables that provide the actuarial value of the interest. The same procedure applies to a property interest transferred at death that does not become effective until a designated future date. The tables

apply to such things as annuities, life estates, term interests, remainder interests, and reversions—all of which are discussed in later chapters.

## Closely Held Corporate Stock

Many nonindustrial forest ownerships are part of closely held family corporations. The term "closely held corporation" does not appear in the IRC or in the IRS regulations. The regulations establish only general valuation rules in the absence of sales or bona fide bid and asked prices. A ruling by the IRS, however, defines closely held corporations as "those corporations the shares of which are owned by a relatively limited number of stockholders" (see Revenue Ruling 59-60, 1959-1 CB 237, modified by Revenue Ruling 65-193, 1965-2 CB 370, and amplified by Revenue Ruling 77-287, 1977-2 CB 319 and by Revenue Ruling 83-120, 1983-2 CB 170).

With closely held corporations, little if any trading in the shares takes place. There is, therefore, no established market for the stock and such sales as may occur at irregular intervals seldom reflect all the elements of a representative transaction as defined by the term "fair market value." In this case, the decedent's stock is an illiquid asset that can present difficult valuation problems for estate and gift tax purposes. Because there is no established market, what valuation criteria should be used? As discussed above, a penalty may be imposed if the value reported is too low.

### Factors to Consider

Although no formula can be devised to determine the fair market value of closely held corporate stock, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. Factors common to most situations include:

1. The nature and history of the business—degree of risk, products produced, services provided, operating assets, and capital structure
2. The economic outlook and conditions for the specific industry in question
3. The book value of the stock and the financial condition of the business
4. Earning capacity (usually considered the most important factor)
5. Dividend-paying capacity
6. Good will or other intangible value
7. Prior arm's-length (on an objective and impersonal basis) sales of stock
8. The market price of stock of similar corporations



Depending on the circumstances, some of these factors may carry more weight than others. Generally, in a family-owned timber corporation, the greatest weight will be accorded to the underlying timber assets.

### Degree of Control

An additional factor to be considered is the degree of control represented by the block of stock being valued. If the decedent held control over the corporation, the IRS may contend that a control premium should be added to the value of the stock in determining its value. In the Tax Court's view, "a premium for control is generally expressed as the percentage by which the amount paid for a controlling block of shares exceeds the amount that would otherwise have been paid for the shares if sold as minority interests ..." (see *Estate of Salsbury, J.E.*, 34 TCM 1441, CCH Dec. 33,503 (M) TC Memo. 1975-333, at 1451). In Technical Advice Memorandum (TAM) 8401006 (September 28, 1983), the IRS National Office ruled that the majority voting power of shares of preferred stock in a closely held corporation owned by the decedent at death was to be considered in valuing the stock for estate tax purposes even though the voting rights expired at the owner's death.

### Valuation Discounts

Among the most important considerations in valuing the stock of a closely held corporation are the legal and operating rights embodied in the stock ownership. One of the most significant of these rights is the ability of certain stockholders to control a company. Conversely, an adjustment commonly is made for the lack of control, by applying a minority discount. The minority interest discount is embodied in the concept that the perceived risk is relatively less when a person has the right to control a company's course of action. As a result of this element of control, a minority stock interest in a closely held corporation owned by a decedent not related to the majority stockholders normally will be valued at substantially less per share than stock that represents a controlling interest (Revenue Ruling 59-60).

**Relative size and ownership concentration**—In addition to control privileges, two equally important factors are the relative size of the block of stock being valued and the concentration of ownership. For example, a person holding a 20-percent minority interest might have little say with respect to operations if a single other shareholder holds the other 80 percent. If, however, the other 80 percent is equally divided between two other shareholders, with an agreement in place that at least 51-percent approval is required for certain decisions, the 20-percent shareholder might have more influence. The first case would warrant a higher discount.

**Lack of marketability**—The minority discount concept is separate and distinct from a lack of marketability discount. In fact, a discount for lack of marketability may exist regardless of whether a controlling or minority interest is being valued; the two types of discounts can exist together or one without the other. While they vary over a wide range, the discount for a minority interest averages 30 percent, while that for lack of marketability averages 42 percent. The lack of marketability discount recognizes that, compared to the broad spectrum of potential purchasers of publicly traded securities, the value of closely held interests is reduced due to a relatively small market. This concept also can apply to majority holdings. The IRS "Valuation Guide for Income, Estate and Gift Taxes," January 1994, recognizes that the absence of a readily available market for closely held stock interests may justify a discount for lack of marketability and states that such a discount is suitable for holdings of less than 50 percent of the voting power.

**Interests controlled by members of same family**—In the past, the ownership of fractional interests other than the interest in question has had a significant influence on whether a discount could be allowed. In many instances, the courts have chosen not to discount the interest in question when all other interests were owned by members of the same family—for example, see *Fawcett, H.K.*, 64 TC 889 (1975). One major exception to this judicial trend was the Fifth Circuit Court of Appeal's decision in *Estate of Bright v. United States*, 658 F2d 999 (Fifth Circuit 1981). Here the decedent's undivided community property interest in shares of stock, together with the corresponding undivided community property interests of the decedent's surviving spouse, constituted a controlling block of 55 percent of the shares of a corporation. The court held that, because the community-held shares were subject to a right of partition, the decedent's own interest was equivalent to 27.5 percent of the outstanding shares and, therefore, should be valued as a minority interest, even though the shares were to be held by the decedent's surviving spouse as trustee of a testamentary trust.

Following the *Bright* decision, the IRS issued Revenue Ruling 81-253, 1981-2 CB 187, which held that, ordinarily, no minority shareholder discount was to be allowed with respect to transfers of shares of stock between family members if, based on a composite of the family members' interests at the time of the transfer, control (either majority voting control or de facto control through family relationships) of the corporation would exist in the family unit. The ruling also stated that the IRS would not follow the *Bright* decision.

In early 1993, however, the IRS issued Revenue Ruling 93-12, 1993-1 CB 202, revoking Revenue Ruling 81-253 and stating that it would subsequently follow *Bright* and several similar decisions in not assuming that all voting power held

by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Now, therefore, stock shares transferred should be able to be valued without regard to the family relationship of the decedent or donee to other shareholders.

**Built-in capital gain tax liabilities**—Discounts now are allowed for built-in potential corporate capital gain tax liabilities. Following two recent court decisions (*Estate of Davis, A.D.*, 110 TC 530 (1998), and *Eisenberg, I.*, CA-2, 98-2 USTC ¶60, 322; 155 F3d 50, revoking and remanding 74 TCM 1046, TC Memo. 1997-483) which rejected the official IRS position of not recognizing built-in corporate capital gain tax liabilities for valuation purposes as enumerated in TAM 9150001 (August 20, 1991), the IRS issued an Action on Decision that agreed that there are no legal prohibitions against recognizing a discount with respect to potential built-in corporate capital gain liabilities [Action on Decision, CCH-1999-001 (February 1, 1999)].

## Partnership and Limited Liability Company Interests

Many nonindustrial forest properties are held in family or nonfamily partnership form, or as part of a limited liability company or limited liability partnership. Limited liability companies nearly always are taxed as partnerships rather than corporations. A partner's capital account in the partnership initially is equal to the value of money and property that he (she) contributes to the partnership and subsequently also reflects the partner's share of profits, minus any losses and distributions. Under State law, unless the partnership agreement provides otherwise, the death of a partner terminates the partnership and requires a distribution of the partnership assets in proportion to the respective capital accounts. From an estate tax point of view, it might be argued that, on dissolution, only the net asset value of the decedent's capital account should be valued. The IRS, however, also considers the value of the business as a going concern—the price a willing, informed buyer would pay and a willing, informed seller would accept for the assets, goodwill, and demonstrated earning capacity. These factors are applicable particularly if the partnership continues rather than being dissolved.

### Valuation Discounts

The principles of Revenue Ruling 59-60, discussed above with reference to valuing corporate stock, also are applicable to valuation of minority general partnership and family limited partnership (FLP) interests (see Revenue Ruling 68-609, 1968-2 CB 327).

Limited partnership minority interests transferred under an FLP are worth significantly less for transfer tax purposes than the same proportionate interests in the underlying assets would be worth. The holder of a minority limited partnership interest cannot make decisions about how the business is run, demand distributions, or force a liquidation of the partnership. In addition, an interest in an FLP may be far less marketable than an equal interest in the underlying assets of the business. As a result, minority interest and lack of marketability discounts generally are allowed on the transfer of interests in an FLP.

Valuation adjustments for a particular FLP interest will vary according to—and must be supported by—the specific facts and circumstances. The primary factors to be considered are:

1. The level of control of the limited partners
2. Limitations on transfer of partnership interests
3. Partnership earnings and revenues
4. The number of partners
5. The nature of the partnership's underlying assets
6. The relevant economic environment for the partnership's business interests
7. The size of the partnership interest being valued

The combined discount for a minority interest and lack of marketability typically is in the 20 to 40 percent range, but can be even higher.

### Deathbed FLP Agreements

In a recent case, a United States District Court in Texas concluded that a decedent entering into an FLP agreement two days prior to her death was pursuant to a bona fide business arrangement, rather than an attempt to transfer property to members of her family for less than full and adequate consideration (see *Church, E.*, DC Texas, 2000-1 USTC ¶60,369, affirmed CA-5, in an unpublished opinion, 2001-2 USTC ¶60,415). The Court concluded that the transaction was a bona fide business transaction because: (1) the primary purpose in forming the FLP was a desire to centralize management and preserve the family ranching operation, (2) the partnership was formed with the possibility of actively engaging in raising cattle in the future, (3) the partnership was not formed solely to reduce the decedent's estate tax, and (4) the decedent had no reason to believe she would die in the near future.

In another case involving Texas law, the Tax Court—in a decision reviewed by the entire Tax Court—rejected the IRS attack against an FLP created by a donor 2 months before his death. The FLP was recognized as having sufficient



substance for Federal estate tax purposes because the partnership: (1) was valid under Texas law, (2) changed the relationships between the decedent and his heirs and creditors, and (3) would not have been disregarded by potential purchasers of the decedent's assets. The Court rejected the IRS argument that, under IRC section 2703(a), the property to be valued was the partnership's underlying assets. According to the Court, neither the language of nor the intent behind IRC section 2703(a) suggested that partnership assets were to be treated as the assets of a decedent's estate where the legal interest owned by the decedent at the time of death was a limited partnership interest (see *Estate of Strangi, A.*, TC 478, CCH Dec. 54,135, affirmed CA-5, on the issue of the property subject to the restriction, reversed with respect to another issue, 2002-2 USTC ¶60,441).

### Limited Liability Company Interests

The valuation implications of limited liability companies (LLCs) are not as clear. Many argue that the valuation adjustments that can be applied to LLCs will be lower than those that can be applied to family limited partnerships. The valuation adjustment issue centers around IRC section 2704(b) which applies to both LLCs and FLPs, and which states that, for estate and gift tax purposes, transfer and liquidation restrictions in LLC operating agreements/ FLP agreements will be disregarded if the entity is family controlled and the restrictions are more restrictive than the governing State law. The problem with respect to LLCs is that the law in most States applies greater transfer restrictions to FLPs than to LLCs. The issue, however, has yet to be resolved and the implications will vary from State to State.

### Forest Land and Timber

Forest land values reflect the general state of demand and supply for timber products in the economy. The demand for timber is affected by many factors such as overall income levels, employment, rate of family formation, supply of mortgage funds, and interest rates. The supply of timber in the market is determined by such things as population changes, the building cycle, the level of existing growing stock, and the general availability of land.

### Methods of Valuation

There are three principal methods used to determine the fair market value of real estate, including forest land (see chapter 12 for a discussion of special use valuation): the market transactions (comparable sales) approach, income approach, and cost approach. One of these usually is selected as the primary approach, but a second or even a third approach

may be used as a check on accuracy if it is applicable and appropriate data are available. In practice, all three methods are ultimately related to the market and should be reconciled when possible.

**Market transactions approach**—Fair market value, based on a comparison of the “subject property” to similar properties (i.e., comparable sales), generally is regarded as the most reliable method of valuation. Value is based on the price for which similar assets were sold under comparable conditions at or near the same time. Other things being equal, this is the method preferred by the IRS.

The price paid for property is a market clearing transaction that provides an expression of the property's fair market value at the time of the exchange. This expression of value must be verified with respect to the relationship of the parties, the terms of sale, date of sale, and the effects of inflation. For price to equal value, the buyer and seller must deal on an objective and impersonal basis. Transactions among family members or business associates always are suspect. When terms other than cash are involved (i.e., mortgages, long-term contracts, etc.), they also must reflect current market conditions for the value-to-price relationship to hold. Favorable terms of trade may reflect hidden benefits. For example, a below-market interest rate will cause the price in question to distort the property's true value. Similarly, undisclosed terms that are unfavorable also could cause the price to mask the true value.

The timing of a transaction is an important factor in estimating an asset's value. In this context the important date is the actual “meeting of the minds” of the buyer and seller rather than the date the deed or other paperwork is recorded. The sale price is then adjusted to reflect the interval that has elapsed between the sale date and the present. The adjustment, of course, is to the extent possible, a determination of fact and not necessarily easy information to obtain.

Finally, the effect of inflation on the purchasing power of the dollar is a critically important factor with respect to transactions that occur at different times. Contracts that fail to adjust for inflation may distort estimates of value, if improperly accounted for in the appraisal process. Transfers in which the assets are encumbered by a mortgage or by contract terms that prevent the price from reflecting the true value should be avoided for comparison purposes.

**Income approach**—The income method of valuation is based on the discounted net present value of future income expected from the property, plus the present value of the property remaining at the end of the income period (i.e., the terminal value). Future values are discounted to the present, using a chosen interest rate that reflects the investor's cost of capital or alternative rate of return. Reasonable estimates

of future revenues and costs may be obtained for many business situations based on past experience. Future values cannot be known with certainty; however, the discounting process weighs the near-term cash flows more heavily than those that will occur in the more distant future. The interest rate used in an income approach valuation is critical. The rate must reflect the opportunity cost of the resources committed to the project as opposed to an alternative use. One problem with the income approach is that prior experience fails to account for future technological change.

It is essential that the components (i.e., cash flows and interest rate) in an income approach calculation of net value be expressed in the same terms with respect to inflation, taxes, and depreciation.

**Cost approach**—The cost approach to valuation is based on the estimated cost of replacing an asset with another of similar quality and utility. The cost and the value of an asset, however, are not necessarily the same. Cost equals value only if the asset is new or yet to be purchased. Caution must be exercised in estimating depreciation when adjusting for obsolescence.

Furthermore, cost equals value only when the property in question is being utilized in its “highest and best use.” Properties often are over- or under-improved. For example, excessive costs for bridge standards higher than necessary for efficient management will not be reflected in estimates of value. Costs must be economically warranted; they reflect the commitment of material and labor resources, which have an opportunity cost for other uses, but whose value represents the right to the present value of the future income stream. Replacement cost is limited by the market to the cost of an item of comparable quality to the one being replaced. Replacement costs frequently differ from reproduction costs due to improvements in both materials and management methods, whether for forest land or other properties.

### Valuation of Bare Land

In valuing forest land, the market transactions approach generally is considered the most reliable. If the appropriate data are available, however, the income approach may be used as a check for accuracy.

The cost approach is inappropriate for valuing bare land because no additional supply of land can be created. Obsolescence, a key component of the cost approach, is a valid consideration with respect to improvements to property such as bridges, fences, and buildings. It is not valid, however, with respect to land or to timber because they are appreciating assets.

**Market transactions approach**—The most reliable method of estimating land value compares the property to similar properties in comparable locations sold within the same time period. As noted above, this is the method preferred by the IRS. If the market is active, and there are a sufficient number of valid comparable sales, the market approach will give a satisfactory estimate of the land’s value.

A critical requirement for using the market approach is access to current land sale data. Land sale information can be found in title insurance company records, the local tax assessor’s and county clerk’s records, appraisers’ and consulting foresters’ files, and real estate brokers’ files. Several sources may be used to obtain a sufficient number of transactions to evaluate the level of economic activity, price trends, and any shifts in forest industry operational patterns.

The price and terms of a sale used for valuation purposes should be verified with either the buyer or seller or both. Sales of forest land typically are private, and the public may receive a distorted picture of the circumstances attending a particular transaction. The price paid may differ from a price paid in the open market due to financing terms, the relationship of the parties, or other collateral factors. The time of the comparable transfer also should be accurately determined in order to make economic adjustments for the time value of money, inflation, and other price influences. If these cannot be determined with confidence for a particular transaction, it should be excluded from the sample for comparative purposes.

With respect to forest land, there are many variables that should be taken into account when comparing sales transfers. These include site productivity, accessibility and operability of the property, the proportion of the tract that is productive, parcel size, location with regard to markets, and regulatory constraints. Because land is characterized by its unitary quality, immobility, indestructibility, and non-homogeneity, the forest land market tends to be highly local in nature. Sometimes even the assumption of indestructibility must be altered to account for factors such as flooding, erosion, soil compaction, or chemical pollution that may affect productivity and ultimately value. Most comparable sales include both land and timber, and many reflect alternative uses of the land.

**Income approach**—With this method, the value of land is based on its income-producing capability (productivity) in its “highest and best use.” The income approach is used when market transactions for comparison with the property of interest are limited or nonexistent. All income from the land—e.g., forest products multiplied by price—during an investment cycle and all costs of production—e.g., labor, management, property taxes, maintenance, and other costs—are discounted to the present and netted. Discounting

is accomplished using an interest rate that reflects the individual investor's highest "alternative rate of return" for his (her) funds if they were to be invested elsewhere. The result is an estimate of the net present value (NPV) of the property for one investment period, typically a rotation. NPV calculated for an infinite investment horizon of timber rotations is known as land expectation value or LEV. This estimate is the maximum bid price for acquiring similar land for growing timber under the same assumptions as to management plan, costs, returns, and interest rate. Alternatively, a terminal value can be inserted at the completion of the rotation period.

Determining the "highest and best use" is a critical assumption for the income approach to valuation of bare land. The unitary nature of land must be considered. For example, a forested property with good road access, lake frontage, or proximity to town may have a higher value for residential or recreational development than for growing timber. The negative impact of such development on the balance of the property must be considered if forest management operations might be restricted in or near the higher valued areas. Combinations of such enhancements and negative impacts should be netted in developing the estimates of the "highest and best use" for such properties.

### Valuation of Merchantable Timber

Forest land in an estate often is valued as a unit; that is, separate valuations are not determined for land and timber. This is a mistake to be avoided. Serious income tax consequences may result due to the lack of an identifiable timber basis when the timber is sold.

**Market transactions approach**—The market value of merchantable timber indicates what the trees would sell for under the prevailing utilization standards in the property's particular timber market area. This value is influenced by factors such as species, tree size, product class, quality, total volume available, and accessibility. Timber markets, like land markets, are highly localized. Because logs are bulky and transportation is expensive, the market area for most timber products is constrained. Generally, the higher the per-unit value of a timber product, the larger its market area. For timber used for undifferentiated fiber products—e.g., firewood, pulpwood, or reconstituted wood products such as oriented strand board—the truck haul radius usually is 100 miles or less; on the other hand, quality sawtimber, poles and piling, and veneer logs may be transported much longer distances.

When timber must be cut to realize current income, it is the timber's current liquidation value that matters rather than its potential future value. Although many comparable sales include the value of the land, timber value alone can readily be established by a timber cruise.

**Income approach**—The value of merchantable timber below rotation age in even-aged stands can be estimated by the income method. This approach presumes an optimum rotation length, or at least an assumed management regime where the expected value of the future harvest and the annual management costs can be estimated. The management costs and terminal value are discounted to the present point in time and subtracted from the expected harvest revenue, also discounted to the present point in time. Such values are potential or imaginary since they require completion of the rotation to be realized and are subject to both uncertainty and risk.

**Cost approach**—Use of the cost approach to obtain estimates of timber value requires using the same assumptions as under the income approach. In this case, the procedure is to compound the establishment cost and the intermediate cash flows forward to the present point in time using an appropriate rate of interest.

Generally, the cost and income approaches will provide estimates of value which differ, based on the interest rate chosen, with one exception. That exception is the special case where the interest rate used is equal to the internal rate of return (IRR)—the compound interest rate that brings the present value of all costs for the assumed management regime equal to the present value of all returns. Use of IRR in income or cost approach calculations illustrates a method for determining standing timber values that has been called the hybrid approach. First, compute the IRR for all costs and revenues in the investment cycle. Second, use the IRR as the interest rate to calculate the cost or income value for the timber investment period. An example of the hybrid approach is found in the following section.

In many cases, it may be more practical to use the income approach to determine the value of merchantable timber than the cost approach. This is because the length of the projection period usually is shorter for an income approach calculation than for a cost approach calculation. Other things being equal, the shorter the projection period involved, the less uncertainty there is in the result.

### Valuation of Premerchantable Timber: A Case Study

**Market transactions approach**—Satisfactory market transactions for valuing premerchantable timber rarely exist, so valuations usually must be based on either the income approach or cost approach. The problem of choosing an appropriate interest rate can be avoided by solving for the IRR of the assumed management regime and using the hybrid approach. As noted above, IRR is the interest rate that brings the present value of all costs and the present value (PV) of all returns equal to each other, or stated differently, brings the NPV of the management regime equal to zero.

This case study is based on an incident where a fire caused by a passing train destroyed a 9-year old pine plantation. The plantation owner had expected to receive net revenue of \$2,075 per acre from the plantation in year 30. Per-acre costs included \$150 for site preparation and planting in year zero, and annual management costs of \$3 per acre. The cost of the land is omitted because it is common to both the cost and income approaches. The IRR can be calculated using an iterative procedure (see tabulation below).

As shown, the IRR that brings NPV equal to zero is approximately 8.44 percent.

**Income approach**—With the income approach, expected future costs and returns are discounted back to the present. Historical costs are not considered because they are “sunk” and have no bearing on future income. With the IRR known, the income value of the 9-year old plantation can be calculated. The general formula for the income approach is:

$$\text{Income value} = \text{Future revenues discounted back to the present} - \text{Future costs discounted back to the present}$$

**Future revenues:** The only revenue is from the harvest at age 30. The formula to calculate the present value ( $V_o$ ) of a single sum ( $V_n$ ) discounted at a given rate of interest ( $i$ ) for the remaining  $30 - 9 = 21$  years of the rotation ( $n$ ) is:

$$V_o = V_n \div (1 + i)^n$$

Substituting:  $= \$2,075 \div 1.0844^{21} = \underline{\$378.48}$

**Future costs:** The only future costs are the annual management costs. The formula to calculate the present value ( $V_o$ ) of a future series of  $n$  annual payments ( $a$ ) at a given rate of interest ( $i$ ) is:

$$V_o = a \times [(1 + i)^n - 1] \div [i \times (1 + i)^n]$$

Substituting:  $= \$3.00 \times (1.0844^{21} - 1) \div (0.0844 \times 1.0844^{21}) = \underline{-\$29.06}$

**Income value:**  $\$378.48 - \$29.06 = \$349.42$

**Cost approach**—The cost approach looks in the opposite direction from the income approach, compounding historical costs and returns forward to the age of the stand. Expected future costs and returns are not considered. As above, with the IRR known, the cost value of the 9-year old plantation can be calculated. The general formula for the cost approach is:

$$\text{Cost value} = \text{Historical costs compounded forward to the present} - \text{Historical revenues compounded forward to the present}$$

**Historical costs:** There are two types of costs in the example. The first is for stand establishment. The formula to calculate the value ( $V_n$ ) of a single historical sum ( $V_o$ ) compounded forward for  $n$  years at a given rate or interest ( $i$ ) is:

$$V_n = V_o \times (1 + i)^n$$

Substituting:  $= \$150 \times (1.0844)^9 = \underline{\$311.02}$

The second type of cost is the annual management expense. The formula for the value ( $V_n$ ) of an historical series of  $n$  annual payments ( $a$ ) at a given rate of interest ( $i$ ) is:

$$V_n = a \times [(1 + i)^n - 1] \div i$$

Substituting:  $= \$3.00 \times (1.0844^9 - 1) \div 0.0844 = \underline{\$38.16}$

**Historical revenues:** There are no historical revenues in this simplified example.

**Cost value:**  $\$311.02 + 38.16 = \underline{\$349.18}$

The hybrid approach applied in this case study has the distinct advantage of eliminating one of the most critical decisions in financial analysis, namely selecting an interest rate. Note also that, except for a small rounding error, both methods of estimating the value of the pre-merchantable stand—the income approach looking forward and the cost approach looking back—provide the same results. This occurs specifically because the hybrid approach uses the IRR to discount future cash flows back and historical cash

Item	Year	Value	PV@	PV@	PV@	PV@	PV@
			9.0%	8.5%	8.4%	8.45%	8.44%
Stand establishment	0	\$ -150.00	\$-150.00	\$-150.00	\$-150.00	\$-150.00	\$-150.00
Management cost	1-30	-3.00	-30.82	-32.24	-32.54	-32.39	-32.49
Harvest revenue	30	2,075.00	156.40	179.53	184.56	182.03	182.53
Net present value			\$ -24.42	\$ -2.71	\$ 2.02	\$ -0.36	\$ 0.04

*dollars*



flows forward to the present. The two approaches will not yield the same results if any interest rate other than IRR is used.

## Reported Timber Specific Court Decisions

### Corporate Stock

*Estate of Jameson, H.B.*, 77 TC Memo 1999-43. The Tax Court allowed a discount for corporate stock owned by a decedent with respect to the potential built-in capital gain tax liability associated with a Texas “C” corporation that held highly appreciated forest land in Louisiana as its primary asset. Due to the fact that the corporation had a valid election under IRC section 631(a), which treats the cutting of timber as though it were a hypothetical sale or exchange of the timber, the Court was able to use a discounted cash flow approach to quantify the tax liability that would be incurred simultaneous to the cutting of the timber. The calculation took into consideration the rate at which the corporation’s timber grew, the effect of inflation, the capital gain tax rates, and the applicable interest rate. Using the appropriate inputs, the Court found that an \$872,920 reduction was appropriate in valuing the stock, a discount of approximately 12 percent from the net asset value.

### Partnership Interests

*Estate of Watts, M.B.*, TC Memo 1985-595, 51 TCM 60 (1985). The Tax Court agreed with the taxpayer that a partnership operating as an active business should be valued as a going business and that a partnership interest discount was appropriate. The partnership was engaged in the management of timber, manufacture of plywood, and sale of lumber. By the terms of the decedent’s will, the partnership was to continue as a going business. The Court considered the liquidation value, asset by asset, to be inappropriate; it adopted the valuation method used by the taxpayer’s appraisers and discounted the decedent’s minority interest by 35 percent. The decision was affirmed upon appeal [*Estate of Watts v. Commissioner*, 87-2 USTC 13,726, 823 F2d 483 (Eleventh Circuit 1987)].

*Harwood, V.Z. v. Commissioner*, [82 TC 239, 267 (1980)]. Here the Tax Court allowed a 50 percent discount based on liquidity and marketability factors for a minority interest in a limited partnership engaged in the timber business.

### Fee Interests

*Estate of Sels, D.W. v. Commissioner*, TC Memo 1986-501, 52 CCH TCM 731, PH TCM 86,501. The Tax Court

compared the in-fee financial interests of the decedent to minority corporate and partnership interests, citing *Estate of Campanari*, 5 TC 488, (1945) and *Estate of Andrews*, 79 TC 938 (1982). Here the value of the decedent’s undivided interests in 11 tracts of forest land was determined using the comparable sales approach. The fractional interests ranged from 2.48 percent to 25 percent. The IRS valuation was revised to reflect differences between the decedent’s properties and the comparison lands with respect to the quality of timber, accessibility, and timing of the sales. The IRS valuation was reduced by a further 60 percent to reflect lack of marketability, lack of control, and the costs of potential partitioning. The estate’s expert witness testified that the purchaser of a minority interest could expect to encounter a significant delay in obtaining the value of the purchased interest and to have little income in the interim. Testimony indicated that partition would be expensive and would take at least 6 years.

*Saunders, G.B. v. United States*, 81-2 United States Tax Cas. (CCH) ¶13, 419; 48 AFTR 2d (P-H) 6279 (1981). Here the Court held that the value of gifted forest land subject to a long-term lease was the present value (using an interest rate that reflected the illiquidity of the property) of the anticipated annual income from the property for the remainder of the lease, plus the residual value of the property at the end of the contract period. According to several commentators, however, the specific discounting formula used by the Court was technically flawed because it discounted real (inflation factored out) cash flows using a current (including inflation) interest rate. The commentators noted this procedure was inconsistent and resulted in undervaluation of the assets.

*Hipp, J.A. et al. v. Commissioner*, TC Memo 1983-746, 46 CCH Tax Ct. Memo 623 (1983). The Tax Court determined the fair market value of forest land for gift tax purposes by relying on appraisal reports and expert witness testimony and then adjusting the sum to reflect changed market conditions at the time of the gift of the same acreage 1 year later. Evidence relating to comparable sales, measurement of soil quality, volume of timber (summation of assets), and accessibility was found to be relevant and was considered by the Court.

*Estate of Sturgis, R. v. Commissioner*, TC Memo. 1987-415, 54 TCM 221. The Tax Court set the value of 11,299 acres of forest land at an amount between the value offered by the estate and that offered by the government. The Court considered the testimony of four experts, all of whom valued the property using the same methodology, by: (1) determining the volume of timber on the property and assigning a separate value to each species; (2) valuing the land as a separate component; and (3) adding the land and timber values together. After considering the testimony

of the four experts, the Court also applied a 20-percent discount factor because of the estate's minority interests in the forest land, which comprised 91 separate tracts.

*Oettmeier, W.M., Jr. v. Commissioner*, 89-2 USTC ¶13,809, 708 FSupp 1307. Here the Court used a so-called "common sense" approach to value a decedent's interest in leased forest land for Federal estate tax purposes. Although the value of the reversionary interest was undisputed, the experts for the estate and for the IRS differed greatly on the value of the future lease payments. The disagreement was based on two items: the choice of an appropriate interest rate and the appropriate discounting formula. The Court rejected the valuations offered by both sides, holding that neither would have been an acceptable price to both a willing buyer and a willing seller. The Court determined the value using its own approach which basically split the difference, but curiously, used two interest rates to arrive at its value.

*Estate of Barge, B.I. v. Commissioner*, TC Memo. 1997-188, 73 TCM 2615. The decedent had been the owner of a 75-percent undivided interest in 60,000 acres of Mississippi forest land. In 1976 she gave a 25-percent interest in the forest land to her three children, and in 1987 she gave a second 25-percent interest to her grandchildren's trusts. On the date of the 1987 gift, the fair market value of the entire 60,000 acres was \$40 million. On the 1987 gift tax return, the 25-percent interest gifted to the trusts was valued at \$2.5 million. The IRS determined that the value was \$12.8 million. The plaintiff's expert used an income capitalization approach to value the 25-percent interest, while the IRS expert relied exclusively on a market comparison approach. The Tax Court accepted the income capitalization approach, but raised the value to \$7.4 million after consideration of a number of related factors.

*Estate of Williams, E.B. v. Commissioner*, TC Memo. 1998-59, 75 TCM 1758. In 1980, the decedent and a relative sold a tract of Florida forest land for \$700 per acre. Shortly before the sale, the decedent had transferred an undivided 50-percent interest in the tract to the relative, but failed to file a gift tax return. In 1983, the decedent conveyed an undivided 50-percent interest in another parcel to the same relative, again failing to file a gift tax return. The decedent died in 1992. After the decedent's death, the estate executor filed gift tax returns for the two transfers, valuing them at \$111.46 and \$119.22 per acre, respectively. The IRS values were \$321.63 and \$427.50, respectively. The Tax Court held that the values of fee interests in the two parcels were \$575 and \$750 per acre, respectively, then applied a 44-percent discount to both gifts for lack of control and marketability and the cost of partitioning.

*Taylor, B.L. v. United States*, 94-1 USTC ¶60,165(DC-AL), affirmed 95-2 USTC ¶60,207, 65 F3d 182 (CA-11). Benjamin Taylor, executor of the estate of Walter Taylor, reported the fair market value of forest land owned by the decedent at \$355,713 on the estate tax return. The IRS, based on an in-house appraisal, placed the value of the property at \$836,704. Before trial, the IRS had an additional outside appraisal performed, and based on that appraisal, adopted a lower value of \$662,704. The jury decided that the value was \$377,585. Taylor then moved for an award of litigation costs. The judge denied the motion, stating that the Court could not conclude that the government's assessments were not substantially justified. The judge found the IRS's outside appraiser to be "fair, impartial, and competent," and his reasoning and methodology "scientifically valid." The differences between the two appraisals were "attributable to reasonable professional differences in the application of technique."

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## Chapter 5

### The Legal Process

#### Basis of the Law

##### Statutory Basis

The Internal Revenue Code, Title 26 of the United States Code, is the primary statutory source of the Federal estate and gift tax law. Known as the Internal Revenue Code (IRC) of 1986, because of the extensive changes made by the Tax Reform Act of 1986 (Public Law 99-514), the IRC is continually being amended by Congress. The tax component of the estate and gift tax planning process is in a constant state of flux. In virtually every year, Congress passes substantive changes and technical corrections to the law.

##### Administrative Basis

**Regulations**—The Internal Revenue Service (IRS) is empowered to administer the IRC. It does this by issuing regulations that interpret the law according to perceived Congressional intent. Other regulations are statutory in nature, dealing with subject matter that Congress failed to legislate in detail. Regulations also serve as an enforcement mechanism. IRS regulations must be issued in proposed form subject to public comment before being published by the IRS in final form. Both interpretive and statutory regulations have the force of law; they may be overturned only by the courts.

**Revenue rulings**—Revenue Rulings are interpretive rulings published by the IRS to apply the tax law to specific factual situations. Although they sometimes have significant general application, the rulings generally have less force than regulations because of their limitation to specific sets of facts. Therefore, they provide valid precedent only if a second taxpayer's facts are substantially identical to those outlined in the ruling.

**Private letter rulings**—These comprise another IRS interpretive tool to apply the tax law to specific situations. Private letter rulings generally are official replies given by the IRS to taxpayer inquiries concerning the tax consequences of proposed transactions. They are limited in application to the taxpayer who made the request, and may not be used as precedent by other taxpayers. Private letter rulings are available to the public under the Freedom of Information Act (FOIA; Public Law 85-619, as amended). Although not comprising general precedent, they can be quite useful as an indication of the IRS position on a certain point.

**Technical advice memoranda**—A technical advice memorandum (TAM) is a special after-the-fact ruling issued by the IRS upon request from either a taxpayer or the IRS auditing agent during the course of an audit. As with a private letter ruling, a TAM is limited in application to the taxpayer who made the request and may not be used as precedent by other taxpayers. Also available under FOIA, TAMs often are used to help interpret IRS positions.

##### Judicial Basis

If a taxpayer disputes the IRS position in a particular matter and the disagreement cannot be settled administratively, the issue may be litigated by the taxpayer filing suit. There are three courts of original jurisdiction for estate and gift tax cases. The Tax Court conducts hearings in most large cities, with or without a formal trial. To file in the Tax Court, a taxpayer must have received a notice of tax deficiency from the IRS and refused to pay. A taxpayer also can turn to the Federal District Court system or to the Court of Federal Claims, which is a single court in Washington, D.C. In both of the latter two cases, the taxpayer must first pay the disputed tax and then file suit for a refund. The District Court is the only one of the three courts in which a taxpayer can request a jury trial in a tax matter. Decisions of the Tax Court and the District Courts may be appealed by either the taxpayer or the government to the Federal Circuit Court of Appeals in the jurisdiction where the taxpayer resides. Appeals from the Court of Federal Claims are taken to the Appeals Court for the Federal Circuit. All appellate decisions may be taken to the United States Supreme Court, but as a practical matter, that court accepts very few estate and gift tax cases.

##### Wills

A will is a legal document that directs the disposition of a decedent's assets. It takes effect at the death of the decedent through the State probate process. A will should not be confused with a letter of last instructions or other nonlegal written statements relating to the decedent's last wishes. These are not legal and binding documents, as is a will.

##### Need for and Advantages of a Will

A person who dies without a will (that is, intestate) leaves the distribution of his (her) property to be governed entirely by State law. In some cases, State law will do exactly what

the decedent had in mind; in other cases it will not. Under State law, all heirs of the same class (children, siblings, etc.) are treated equally if there is no will. There generally is no way the court can alter the distribution of the estate assets.

The advantages of a will are many. With a will, a person can dispose of his (her) property as he (she) wishes within the limits of the law, can name the executor of the estate, and can save probate expenses by waiving (not requiring) bonds and some other expenses. Also, guardians for minor children can be named in a will, and charitable bequests specified. With a will, the testator can stipulate that certain estate assets go into a trust to be created at the testator's death. Without a will, this cannot be done.

### **Will Preparation and Execution**

The exact legal requirements for preparing and executing a will vary by State and must be followed for the will to be valid. Even handwritten wills must meet certain legal specifications. Only dispositions and other provisions in a will that are permitted by law are valid; any portions that do not follow the law are invalid. An attorney always should be consulted when writing a will. An important point to remember is that, with respect to real property, the law of the State in which the property is located will govern its disposition, not the law of the State in which the owner resides if the two are different. This is an important consideration for forest landowners with holdings in a State or States other than their State of residence. The cost of a will is generally minimal—usually less than the cost of the bond that must be posted if there is no will.

### **Joint, Mutual, and Reciprocal Wills**

A joint will is a single will executed by two or more individuals. A mutual will is one made pursuant to an agreement between two or more persons to dispose of their property in a special way. The will in such a case may be joint, or there may be separate wills. Reciprocal wills are those in which each testator names the other as his (her) beneficiary, again either in a joint will or in separate wills. Even when State law permits, it generally is undesirable for persons to bind themselves with joint, mutual, or reciprocal wills; they run the risk of being unable to deal with changed circumstances upon the death of one of the parties. If executed by spouses, such wills can jeopardize the marital deduction (discussed in chapter 6). The safest procedure is for each spouse to execute a separate will, with no provisions that restrict the survivor's freedom of disposition.

### **Changing a Will**

A will may be revoked, modified, or changed at any time before death. All changes, however, must be made in

accordance with State law. Minor changes can be made by preparing a codicil, which is a short attachment to an existing will. In some States, a will may become invalid if the person making it subsequently has a child, including an adopted child, unless there is a provision in the will to the contrary. In such cases, a new will must be written.

### **Power of Attorney**

A power of attorney is a legal document prepared under State law by which the grantor transfers the right to legally act for him (her) to another person. A power of attorney can be limited to only certain acts or may be a general power of attorney covering all actions permitted by State law. Powers of attorney may be revoked at any time by the persons granting them, by executing a written revocation in the format provided by State law. They are revoked automatically by the death of the grantor, and usually also by the grantor becoming incompetent, unless the instrument is a durable power of attorney, as described below. Revocable trusts (see chapter 9) sometimes are used instead of powers of attorney. Under a revocable trust, the trustee can act even if he (she) is unable to ascertain whether the grantor still is alive and even if the grantor becomes incompetent.

### **Durable Power of Attorney**

Most States now permit durable powers of attorney, which survive the incompetency of the grantor. For example, New York law allows a principal to provide that his (her) subsequent disability or incompetency shall not automatically revoke or terminate the authority of an attorney-in-fact who acts under a power of attorney.

### **Springing Power of Attorney**

Most States now also permit so-called "springing" powers of attorney. A springing power of attorney becomes effective only when the grantor becomes incompetent. Under most State laws governing durable and springing powers of attorney, the attestation of two physicians is required to establish incompetency.

### **Probate**

Probate is the legal process designed to protect, administer, and distribute a decedent's estate. It includes proving the validity of the will. Probate courts exist to protect the rights of the heirs or legatees, supervise the assembling of the estate assets, and assure proper and orderly distribution of the assets, either by terms of the will or in accordance with State statutes in the absence of a will. Basically, the probate court performs the same function in all States, although its name may vary from one State to another.



## Probate Administration and Costs

The existence of a will does not necessarily avoid probate; in most cases, it still is necessary for the court to supervise distribution of the estate assets. Under some circumstances, depending on the type of property ownership involved and State law, all assets of an estate need not go through probate. In many States, for example, property owned jointly between a husband and wife automatically passes to the survivor upon the death of the other (see chapter 14 for a discussion of spousal joint ownership).

Other assets that do not pass through probate include life insurance policy proceeds (unless payable to the insured's estate), individual retirement account (IRA) balances (unless payable to the insured's estate), and some U.S. Government savings bonds (dependent upon how ownership is titled). Federal law governs the disposition of these items.

Probate administration includes such matters as the assembling of estate assets, payment of debts and taxes, clearing title to real property, and distribution of items to the heirs/legatees. In most cases, a final income tax return must be filed for the decedent. During administration of the estate, one or more fiduciary (estate) income tax returns also may have to be filed. In most cases, the executor named in the will, or the administrator appointed by the court if there is no will—together with the attorney for the estate—actually handles these details, but always under the Court's supervision.

Probate costs vary among States and depend on the attorney's fee schedule, and on the size and complexity of the estate. In addition to the attorney's fee, there are court costs, the administrator's or executor's fee unless waived, and the cost of the administrator's or executor's bond unless waived. Although it is difficult to generalize, costs typically range between 2 and 6 percent of the value of the estate.



## **PART II**

# **APPLICATION OF GENERAL ESTATE PLANNING TOOLS TO FOREST LAND**



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## Chapter 6

### Use of the Marital Deduction in Estate Planning

#### Overview

The marital deduction, considered by many the most important estate tax saving device available, provides a deduction from the adjusted gross estate for all property passing to the surviving spouse. The deduction originated in 1948 when tax-saving provisions related to property passing to a surviving spouse that had been available only in community property States were extended to individuals in all States. The provisions were expanded several additional times, until the Economic Recovery Tax Act of 1981 (ERTA, Public Law 97-34) provided an unlimited deduction for both lifetime and testamentary gifts to spouses. The marital deduction today recognizes both spouses' contribution to the family's assets. Wills written before 1982 that contain a marital deduction clause based on pre-ERTA law should be reviewed and amended if the clause will produce an unsatisfactory result based on current law.

#### Qualifying for the Marital Deduction

The decedent's estate can claim a deduction—the marital deduction—for qualifying lifetime and testamentary (by will at death) transfers of property to a surviving spouse. As noted above, the deduction for both lifetime gifts and testamentary transfers is unlimited. The property actually must pass from the decedent to his (her) spouse; thus, the marital deduction is not available to estates of widows, widowers, or unmarried persons.

Neither is the marital deduction available for gifts or bequests made to spouses who are not United States citizens, unless they are made using a qualified domestic trust. In order to qualify the trust instrument must provide that at least one trustee be a United States citizen or domestic corporation, and that any distribution from the trust principal be subject to the United States trustee's right to withhold the estate tax due on the distribution.

#### Status as Surviving Spouse

The person receiving the decedent's property for which a marital deduction is claimed must qualify as a "surviving spouse" on the date of the decedent's death. A legal separation that has not terminated the marriage at the time of death does not change the status of the surviving spouse. If, however, an interest in property passes from the decedent

to a person who once was the decedent's spouse but was not married to the decedent at the time of death, the interest is not considered as passing to a surviving spouse. If a decedent's divorce from a prior spouse is declared invalid by a State court having jurisdiction, the Internal Revenue Service (IRS) will not allow a marital deduction for the decedent's bequest of property to a subsequent spouse (Revenue Ruling 67-442 CB 65).

A transfer by the decedent during the decedent's lifetime to an individual to whom he (she) was not married at the time of the transfer but to whom he (she) was married at the time of his (her) death and who survives the decedent is a transfer by the decedent to his (her) surviving spouse with respect to gifts includible in a decedent's gross estate under section 2035 of the Internal Revenue Code (IRC).

#### Transfer of Property Interests

To be eligible for the marital deduction the decedent must have been a citizen or resident of the United States at his (her) death. The estate tax marital deduction allows a deduction equal to the value of the property included in the decedent's gross estate that actually passes to the surviving spouse, and which is not a non-qualified terminal interest (IRC section 2056). Not only must the value of the property interest be included in the decedent's gross estate, but it must also be of a type that will be included in the surviving spouse's gross estate to the extent that it is not consumed or given away during the spouse's lifetime.

Property left with no strings attached—an absolute interest—qualifies for the marital deduction. The terminal interest rule [IRC section 2056(b)] generally does not permit a marital deduction for property interests that are terminal interests. A terminal interest is an interest in property that will terminate or fail on the lapse of time or on the occurrence, or failure to occur, of some event or contingency. Examples include life estates, annuities, and property given to a surviving spouse that would revert to the children if the surviving spouse remarries. The purpose of this rule is to require that if property is transferred to the surviving spouse it will be included in the surviving spouse's estate unless disposed of during the surviving spouse's lifetime. Whether or not an interest is a terminal interest is determined by State law at the death of the decedent. Whenever trust between spouses is lacking and conditions are attached to gifts or bequests, the use of the marital

deduction is on shaky ground. As discussed below, there are certain exceptions to the terminal interest rule.

Examples of eligible property transfers to the surviving spouse include: an outright bequest by will; a power of appointment; life insurance proceeds; joint tenancy survivorship; transfers by annuity, insurance, or other contract; and intestate transfers under State law. In summary, any property left with no strings attached is an absolute interest and qualifies for the marital deduction.

Property interests passing to a surviving spouse that are not included in the decedent's gross estate do not qualify for the marital deduction. Expenses, indebtedness, taxes, and losses chargeable against property passing to the surviving spouse will reduce the marital deduction.

### **Exceptions to the Terminal Interest Rule**

Each spouse must trust the other implicitly for the marital deduction to work effectively. There are five exceptions to the terminal interest rule: (1) qualified terminal interest property (QTIP), (2) general power of appointment, (3) survivorship condition, (4) right to payment, and (5) income interest. These exceptions generally stipulate that the property interests in question will qualify for the marital deduction if certain requirements are met. They also will be taxable in the surviving spouse's estate if not consumed or given away before his (her) death. The most important of these exceptions is the QTIP election.

#### **QTIP Election**

Property under a QTIP election is eligible for the Federal estate tax marital deduction. Under this election, the value of the property is included in the surviving spouse's estate at his (her) death. A more detailed discussion follows.

#### **The General Power of Appointment**

The general power of appointment is the right to determine the ultimate disposition of certain designated property. When a decedent gives his (her) spouse an interest for life, together with a general power of appointment, the possibility of exclusion from the surviving spouse's gross estate is substantially removed. The survivor must have a life interest that entitles him (her) to all the income (payable at least annually), and he (she) has the power to appoint the property to himself (herself) or his (her) estate. Such transfers are permitted to qualify for the marital deduction as exceptions to the terminable interest rule as long as certain conditions are met [IRC section 2056(b)(5)].

#### **Survivorship Condition**

A bequest to a spouse may be conditioned on his (her) survival for a specified period, not to exceed 6 months, after the death of the decedent. It also may apply to a common disaster, providing the spouse does in fact survive the decedent.

#### **Right to the Payment**

The surviving spouse must have a right to the payment of life insurance, endowment, or annuity proceeds, coupled with a power of appointment for the survivor or the survivor's estate. Annuities payable from a trust and commercial annuities qualify.

#### **An Income Interest**

The survivor must have an income interest in a charitable remainder unitrust or annuity trust (see chapter 9) where he (she) is the only non-charitable beneficiary. These conditions apply automatically; however, the executor can elect for these provisions not to apply.

### **QTIP and the Marital Deduction**

A QTIP is a special form of life estate interest given to a surviving spouse that qualifies for the marital deduction. With a QTIP, the estate owner (first spouse to die) can control the disposition of the remainder interest after the surviving spouse's death (i.e., the property will pass to the children or other beneficiaries the estate owner designates). For example, forest property may be put into a QTIP, with the value qualifying for the marital deduction. The surviving spouse receives the income from the property for life, with the remainder interest passing to the children or other designated beneficiaries at his (her) death.

The amount of the marital deduction resulting from the QTIP election is the net value of the property involved, after reduction of indebtedness charged against it. The debt to be reduced from the property value includes any estate taxes charged against the property.

#### **Qualification for the QTIP**

The QTIP interest must specifically be elected by the executor of the estate on the estate tax return. Once made, it is irrevocable. Failure to make the election also is irrevocable. In certain limited circumstances, a protective election can be made [Treasury Regulation 20.2056(b)-7(c)]. To qualify, the following conditions must be met: (1) the surviving spouse must be entitled to all of the income from the designated property payable at least annually for

his (her) life (this income interest is known as a “qualifying income interest”); (2) a QTIP interest in property not placed in trust must provide the survivor with rights to income that are sufficient to satisfy the rules applicable to marital deduction trusts; and (3) there must be no power of appointment in anyone, including the spouse, to appoint any part of the property subject to the qualified income interest to any person other than the spouse during the spouse’s life. Use of a marital deduction formula, as discussed below, to determine the amount of property passing to a QTIP does not jeopardize the QTIP election (Private Letter Ruling 8814002, October 29, 1987).

The marital deduction is available when the spouse is entitled to all the income from the entire interest in the property, or to the income from only a specific portion of the property. Under IRC section 2207A, the surviving spouse’s estate is entitled to recover from the person receiving the QTIP property the portion of the estate tax attributable to the inclusion of the property in the surviving spouse’s estate, unless the surviving spouse directs otherwise by will. Previously, a general provision in the will that all taxes be paid by the estate was sufficient for this purpose. Under the Taxpayer Relief Act of 1997 (Public Law 105-34), however, such a general provision is no longer sufficient to waive the right of recovery. To waive the right of recovery, the decedent must indicate in the will (or revocable trust) a specific intent to waive such right.

### Contingent Income Interests

Generally, an income interest will not qualify for QTIP treatment if it is contingent on the occurrence of some event. One exception to this rule is making the interest contingent on the executor making a QTIP election [Treasury Regulation 20.2056(b)-7(d)(3)(i)].

### To What Extent Should the Marital Deduction Be Used?

The marital deduction is a powerful planning tool which must be used carefully in order to meet both the forest landowner’s objectives and legal constraints on the transfer of property. The survivor’s estate, his (her) general state of health, and his (her) ability to manage additional resources efficiently also are factors to be considered.

### Legal Rights

Legal rights of the surviving spouse—called dower and curtesy (surviving spouse’s marital right)—to take a share of the real property and sometimes personal property in the estate, must be taken into account in deciding how much and in what form property should pass to the surviving spouse.

The rights of dower and curtesy, under various names, are governed by State law. These decisions will be affected by the presence of children from the current and perhaps former marriages of either or both spouses.

### Nontax Factors

Nontax factors that may affect use of the marital deduction include the nature of the couple’s personal relationship, each spouse’s confidence in the other’s ability, and the likelihood that the surviving spouse will remarry. Spousal trust permits equalization of the estate’s resources (necessary for the marital formulas to work regardless of which spouse is the first to die) and freedom to use all the planning tools that are available to save taxes. On the other hand, lack of trust or fear of a divorce or that the surviving spouse will remarry may force the owner to maintain maximum control, which complicates the planning process.

The surviving spouse’s resources and possible inheritances from other sources should be taken into account in projecting tax outcomes. When young children are present, their needs must be taken into account as well. The value of both spouses’ estates and the effects on each other’s estate tax return should be considered. Other factors include the disposition of a personal residence, which often has a high sentimental value to the surviving spouse.

### Marital Deduction Deferral

The marital deduction defers the estate tax until the surviving spouse’s death; therefore, the estate taxes of both spouses must be considered. If, however, the goal simply is to save the maximum estate tax at the death of the first to die, the marital deduction should be used to the fullest extent possible. A will that states, “I leave everything to my spouse,” results in the deferral of all estate taxes on the death of the first to die. This may, however, create a huge tax problem for the estate of the surviving spouse, especially if that person already has a substantial estate of his (her) own. When the survivor’s health is good and life expectancy is relatively long, the deferral gives time for him (her) to do further estate planning. A number of tax factors, as follows, should be considered.

**Maximize credit**—Maximizing use of the applicable exclusion amount in each spouse’s estate is the key to effective use of the marital deduction. The \$780,800 applicable credit amount (2006 through 2008 under the law in effect at this writing) permits each spouse to transfer \$2 million in net taxable estate value to persons other than the other spouse—for example the children—without incurring an estate tax. Together, two spouses can pass \$4 million in net taxable value to other persons without estate tax cost.

**Example 6.1.** Assume a husband, a forest landowner, owns 1,200 homogeneous acres of pine timber with a net value of \$3 million after payment of estate debts and administrative costs. His wife is without assets (the analysis works the same with husband and wife's roles reversed). If he wills her the entire estate with a marital deduction bequest, his estate will pay no tax. When the wife dies, with income earned used to pay interim living expenses, funeral expenses and administrative costs, her estate will face a Federal estate tax of \$450,000 on the \$3 million value of the inherited forest land (through 2008), reducing by 15 percent the amount of the estate that passes to the children. The tax may have to be paid by selling part of the property, or using IRC section 6166 (see chapter 13) to pay the tax in installments, from timber sale income.

Having assets concentrated in one spouse's estate, as in this example, presents considerable risk, since the spouse without assets may be the first to die and the opportunity to use the marital deduction wasted. This situation can be remedied easily by the husband making a large lifetime gift (see chapter 8) to the wife. Balancing the spouses' estates in this way ensures that the marital deduction can be used and also permits use of the applicable credit amount at both deaths. Spousal trust is essential for this strategy to work.

**Balancing the marital deduction**—The goal is to balance the expected values in each estate with adjustment for life expectancy, earning power, and the ability to manage forest land or other assets.

**Example 6.2.** Assume the same facts as in example 6.1, except now the husband makes a lifetime gift of \$1 million in forest land value (400 acres) to the wife, removing it from his estate. At his death, he makes an outright bequest of \$1 million in forest land value (400 acres) to the children. The bequest is protected from estate tax by the applicable credit amount, which could shield \$2 million in net taxable estate value from estate tax, if needed. He wills the remaining forest land value (400 acres valued at \$1 million) to his wife using a marital deduction bequest, and his estate pays no estate tax on it. When the wife dies, her estate also has an applicable credit amount of \$780,800, which shields the entire amount of her \$2 million net taxable estate from estate tax and prevents any reduction in the amount that passes to the children.

While it addresses the shortcomings of example 6.1, this example has the disadvantage that the wife loses the control and use of one-third of the forest land estate that she helped to accumulate. This may mean a diminished lifestyle for her, a problem that could be remedied by using a trust (see chapter 9) instead of an outright bequest to the children.

**Example 6.3.** Assume the same facts as in example 6.2, but now the \$1 million bequest to the children is put into a non-marital or credit by-pass trust from which the wife has income for life. Now, she has access to the same level of income as in example 6.1. If desired, a clause can be included in the trust that permits invasion of the trust principal subject to an ascertainable standard of living (see chapter 9).

This example provides for use of the marital deduction regardless of which spouse is the first to die and use of the applicable credit amount at the death of both the husband and wife, while providing the surviving spouse access to the income generated by the full estate during his (her) lifetime.

**Survivor's ability**—The surviving spouse's ability and willingness to reduce the size of his (her) estate must be considered. As well, the spouses' goals with respect to the welfare of the children must be compatible.

To summarize the optimum marital deduction strategy: (1) it must be used in conjunction with the applicable credit amount; (2) it must be used with regard to the survivor's estate; and (3) consideration must be given to the survivor's ability, health, and willingness to reduce the remaining estate to minimize estate tax liability. Generally, the marital deduction is used to defer the tax at the first spouse's death so that additional planning can be done by the surviving spouse.

## How to Make a Marital Deduction Bequest

### Basic Patterns

A bequest that qualifies for the marital deduction may be made as an outright gift (see chapter 8), a direct bequest to the surviving spouse, or by trust for his (her) benefit (see chapter 9). In any case, the transfer usually will fall into one of the following patterns.

**Property**—An outright bequest of specific property may be made in these terms: "I give my wife the 600 acres of forest land that I own (legal description) in Laidback County, Forested State."

**Example 6.4.** Assuming the same facts as in example 6.2, but specifying that the timber is organized into three 400-acre management units of different age classes: (1) a premerchantable plantation, (2) small sawtimber, and (3) mature sawtimber. It might be advantageous if the husband's lifetime gift and bequest to the wife were made specifically from the small sawtimber and mature sawtimber management units,



for two reasons. First, it would provide liquidity to meet her immediate income needs. Second, it would permit his bequest to the children to be made from the premerchtable plantation management unit—either outright or by using a non-marital or credit by-pass trust—preventing that rapidly-appreciating asset from entering the wife’s estate.

**Example 6.5.** Assuming the same facts as in example 6.4, but specifying further that the premerchtable trees in the plantation management unit are valued at \$600 per acre; the timber in the small sawtimber unit is valued at \$1,500 per acre, primarily as chip-n-saw; the timber in the mature sawtimber unit is valued at \$3,750 per acre; and the land on which the timber stands has a bare land value of \$1,500 per acre. This reflects the potential value of a managed forest property. The total value of the timber is \$2,340,000 [(\$600 per acre x 400 acres) + (\$1,500 per acre x 400 acres) + (\$3,750 per acre x 400 acres)] and the value of the land is \$1,800,000 (\$1,500 per acre x 1,200 acres), for a combined total of \$4,140,000 (\$2,350,000 + \$1,800,000). In this case, both the husband’s lifetime gift and bequest to the wife can be made primarily from the mature sawtimber management unit, which could be sold immediately, if necessary, to generate cash. Note: In many instances only 75 to 80 percent of forested property is operable due to roads, streamside management zones, etc., which are ignored here for simplicity.

**Money**—A bequest of money is known as a “pecuniary bequest.” It can be phrased as “I give my husband \$1 million.” This statement alone does not necessarily make it so, however; the resources to generate the cash must be available in the estate.

**Fractional share**—The owner can give a straight fractional share, that is, “I give one-half of my residuary estate, outright, to my wife.” The residuary estate is what remains from the gross estate after payment of debts, administrative expenses, other charges, and specific bequests.

### Formula Marital Deduction Bequests

Other things being equal, the preferred approach would be to use a formula marital deduction bequest that sets aside the largest amount that can pass free of Federal estate tax by way of the applicable credit amount. This circumvents the problems generated when the bequest amounts have appreciated (or depreciated in some cases, but rarely for timber). There are three basic formula clauses that normally are used: (1) pecuniary marital deduction; (2) pecuniary unified credit; and (3) fractional residuary marital reduction. Numerous variations and refinements can be applied to each.

**Pecuniary marital deduction**—The pecuniary marital deduction formula is easy to express, and may offer the greatest opportunity for postmortem planning. The bequest can be made outright or in a marital deduction trust (see chapter 9). It directs that the amount of the marital share for the surviving spouse be the sum that minimizes the Federal estate tax payable. The residual share corresponds to the applicable exclusion amount, plus the Federal deduction for State death taxes.

**Example 6.6.** Assume the same facts as in example 6.4. The pecuniary marital deduction share can include the premerchtable management unit. This places growth and value appreciation in that portion of the first spouse’s estate that will not be taxed again at the second spouse’s death. Amounts in excess of \$2 million in the marital share (2006 through 2008) can be consumed or gifted to reduce the second spouse’s estate tax value.

**Pecuniary unified credit**—The pecuniary unified credit formula (usually in trust form; see chapter 9) is similar to the pecuniary marital deduction formula. It directs that an amount equal to the applicable exclusion amount, plus the Federal deduction for State death taxes, if appropriate, be given outright or in trust. The residual estate in this case will constitute the marital deduction amount that also can be outright or in trust. The results are similar to example 6.6 with respect to appreciation and liquidity.

**Fractional residuary marital deduction**—The fractional residuary marital deduction formula directs to the survivor the smallest fraction that minimizes the Federal estate tax payable. Although it is harder to calculate than the pecuniary formula—shares can be determined only after a final accounting by the executor—appreciation of estate assets is shared by the spouse and other beneficiaries. This may be a desirable outcome in terms of family relationships even if it costs some additional tax.

### The Choice of Marital Deduction Formula

Which marital deduction formula to use depends on the gain (or loss) potential of estate assets, preferences about whether the surviving spouse or children or both should benefit from the appreciation (or bear the burden of depreciation) in the estate’s timber assets, estate taxes that may be due at the surviving spouse’s death, and family relationships. The choice should be made only after an analysis of financial and tax considerations, with emphasis on the personal preferences of the individuals involved.

**Timber assets**—Treatment of timber assets should be dictated by the landowner’s goals as expressed in the forest management plan. These include continuity of management,

keeping the forest property intact as a management unit, financial targets, and nonmonetary considerations of the family. Integrating the forest management plan into the overall estate plan can be facilitated if the forest management plan has an estimate of current value by stand or management unit, a projection of net cash flows over the immediate planning horizon (operational plans usually are for 5 years, but sometimes up to 10 years), and a projection of the timber value at the end of the planning period.

Timber assets are dynamic, appreciating (or occasionally depreciating) in response to weather and markets. Their current value depends on the distribution of timber stands as affected by volume of merchantable timber and product classes (see chapter 4). Timber assets usually appreciate but present particular challenges due to their unitary nature, the fact that income usually is available only periodically, and illiquidity. Appreciation, moreover, will vary with market fluctuation and the stage of the growth cycle that stands are in at a particular time.

**Life insurance**—Life insurance proceeds may qualify for the marital deduction in numerous ways, but a life insurance specialist should be consulted to ensure both the marital deduction qualification and the best financial choice for the heirs. It is imperative that the policies be carefully coordinated with the overall estate plan with respect to

policy ownership, beneficiaries, and settlement options. Otherwise, the financial advantages of insurance may be dissipated, and the needs of the beneficiaries left unmet or only partially served (see chapter 10).

**Personal effects**—Special attention should be given to the treatment of personal effects when using a marital deduction formula. Many family heirlooms are difficult to value or equitably divide. The decedent and heirs often have specific attachments that should not be ignored, but should be handled separately.

**Disclaimer**—In making a marital deduction bequest, it may be desirable to provide in the will that the surviving spouse can refuse to accept any part of the marital bequest, creating the opportunity for a second look at the outcomes (see chapter 7).

**State death taxes**—The applicable State death taxes, if any, should be reviewed and included in drafting the marital deduction formulas and other analyses. State death taxes often do not conform to the Federal estate tax model and can upset plans if not incorporated. This is especially the case now that the State death tax credit for Federal estate tax purposes has been replaced with a deduction, in effect cutting the State taxes adrift from the Federal tax (see chapter 18).

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## Chapter 7

### Disclaimers, Settlements, and Elections to Take Against the Will

#### General Considerations

Sometimes a decedent's best laid plans do not materialize. Assets may appreciate or depreciate in value, an unexpected gift may be received, or a loss may occur. Estate adjustments may not have kept pace with fast-moving events. Perhaps the decedent was merely careless or neglectful, and at death it is too late to change his (her) plan for disposing of property. Fortunately, the heirs or legatees often can make certain changes after the decedent's death through disclaimers, settlements, and the election to take against the will.

#### Disclaimers

No one is required by law to take what is due to him (her) under another person's will or by virtue of the State laws of inheritance in the absence of a will. The bequest or legacy can be disclaimed. A qualified disclaimer for estate purposes is defined as the irrevocable and unqualified refusal by a beneficiary to accept property during probate under authority of section 2518 of the Internal Revenue Code (IRC). Disclaimers can be utilized to effectively realize certain postmortem estate planning benefits that were not established prior to the decedent's death. An example would be a decedent's child disclaiming a taxable legacy in order to allow it to pass to the surviving spouse, in order to take full advantage of the marital deduction. Another example would be a surviving spouse disclaiming part of his (her) legacy from the decedent so that it will pass to the children and not waste the applicable exclusion amount.

If a qualified disclaimer is made by someone who does not wish to accept an interest in property, the interest disclaimed will be treated for Federal tax purposes as if it had never been transferred to that person. Rather, it is considered as passing directly from the decedent to the person entitled to receive it as a result of the disclaimer. Additionally, the disclaimant will not be treated as having made a gift, for either estate or gift tax purposes, to the person to whom the interest passes by reason of the disclaimer.

#### Disclaimer Requirements

IRC section 2518 provides a single set of definitive rules for qualified disclaimers for purposes of the estate, gift, and generation-skipping transfer taxes. Four basic requirements must be met:

1. The refusal must be in writing.
2. The written refusal must be received by the transferor, his (her) legal representative, the estate representative, or the holder of legal title to the property not later than 9 months after the later of the day on which the transfer creating the interest is made, or the day on which the person making the disclaimer reaches age 21. *Estate of Fleming, J.K.* [92-2 USTC ¶60,113, 974 F2d 894 (CA-7), affirming TC Memo 1989-675, 58 TCM 1034 (1989)] clarified that a disclaimer by a non-minor of an interest created by a decedent's will must be made within 9 months of the date of the decedent's death, not within 9 months after the will was admitted to probate.
3. The disclaiming party must not have accepted the property, any interest in it, or any of its benefits before making the disclaimer.
4. The property disclaimed must pass to someone other than the person making the disclaimer, as a result of the refusal to accept, and without any direction on the part of the disclaimant. However, valid disclaimer may be made by a surviving spouse even though the interest passes to a trust in which he (she) has an income interest—provided that there was no direction on the surviving spouse's part to do so.

**Receipt of consideration**—A disclaimer is not qualified if the disclaimant receives consideration in exchange for the disclaimer. A mere expectation or unenforceable hope that something will be received in the future, however, does not rise to the level of consideration. To render the disclaimer invalid, the decision to disclaim must be part of a mutually bargained-for consideration.

#### Interaction of State and Federal Law

A timely written transfer of the property by the person disclaiming it to the person who would have received it under a disclaimer that is valid under State law also is considered a qualified disclaimer. However, requirements (2) and (3) above must have been met [IRC section 2518(3)].

A qualified disclaimer under Federal law will apply even if State law does not characterize such a refusal as a disclaimer. Also, the Federal time limits prescribed for a qualified disclaimer will supersede the time period prescribed by State law.

## Disclaimer Provisions in the Will

In the absence of a contrary provision in the will, disclaimed assets go to those persons who would have received them if the disclaiming party had predeceased the estate owner. If, however, there is a possibility that a disclaimer might be a useful postmortem tool, it would be advisable to make provision for disclaimers in the will. These could include the requirement that a written statement be delivered to the executor within the requisite time limits, stipulations for disposition of disclaimed bequests, and details as to what is required to assure the effectiveness of a disclaimer for Federal and State tax purposes (various States have further requirements of their own in addition to the Federal requirements listed above). The provision in the will that disposes of a disclaimed bequest is extremely important to the disclaimant. As noted above, the disclaimant cannot disclaim in favor of anyone of his (her) choice; all the disclaimant can do is refuse to accept the bequest and allow it to pass under the alternate provision in the will.

## Disclaimers by the Surviving Spouse

If the surviving spouse's marital deduction bequest provides more than he (she) may need or consume, the additional amount will be includable in his (her) estate, which might result in the beneficiaries of the surviving spouse receiving less than they might otherwise receive. In this case, the surviving spouse might choose to disclaim all or part of the bequest. If the disclaimer will result in the disclaimed property passing to those whom it is desired to benefit (for example, the children), the property in question would never be included in the surviving spouse's taxable estate. It would pass to the intended beneficiaries without gift tax liability and without any added transfer expenses (see chapter 14 for limitations on using a disclaimer for jointly held property).

A point to consider is that a disclaimer of a marital deduction bequest may serve to increase the estate tax liability of the decedent's estate unless it is made in favor of a charity or the unified credit is available to offset liability. But even if additional estate tax results for the decedent's estate, the disclaimer could possibly reduce the estate tax and administration costs of the disclaimant's estate. These factors all have to be considered.

## Disclaimers in Favor of a Surviving Spouse

If a surviving spouse is to receive a marital deduction bequest considered to be less than adequate for his (her) needs and there are bequests to others, the other beneficiaries may wish to disclaim their bequests in whole or in part. The effect of this strategy would be to increase the marital deduction and thus reduce estate taxes. IRC section 2056(a) permits an estate tax marital deduction for property

disclaimed by a third person that passes in favor of the surviving spouse. If the disclaimed assets are not necessary for the surviving spouse's needs, gifts in the amount of the disclaimed bequests could later be made to the original beneficiaries in installments that would minimize or eliminate gift taxes.

## Charitable Disclaimers

IRC section 2055(a) allows a deduction for a charitable transfer resulting from a disclaimer. For example, if a decedent's will provides for a charity to receive a disclaimed bequest, a disclaimer may reduce estate taxes and, at the same time, take the bequest out of the disclaimant's estate. In this situation, however, there are income tax considerations to be taken into account. If the bequest is accepted and then given to charity, the legatee-donor will get an income tax deduction. The value of that deduction must be weighed against any higher estate taxes resulting from acceptance of the bequest.

## Will Settlements

A will contest or settlement can result in a shift of property interests from one beneficiary to another or from a beneficiary named in the will to a person not named. The courts have held that no gift results if the contest or settlement is bona fide and at arm's length. In other words, the shift of property interests has the same effect as a disclaimer.

## Election Against the Will

If a will does not give a surviving spouse a prescribed share of the testator's estate, many States permit the surviving spouse "to take against the will" to make up the difference. If the surviving spouse makes this election, he (she) will get a larger share of the estate. At the same time, the election may increase the marital deduction, thereby reducing the estate tax. Again, as with a disclaimer, the shift of property interests will not result in a gift being made by the surviving spouse.

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## Chapter 8

### Gifts of Forestry Assets

#### Overview

Estate planning frequently focuses on the transfer of property at death; however, lifetime gifts also offer a powerful tool to achieve planning objectives. With a program of giving, the “ability to afford the gift” should be the first consideration. That is, do not give away money or forest land that might someday be needed. Many gifting objectives are personal and do not involve tax saving, but they can be just as—or perhaps more—important than tax and financial considerations. Careful attention to the tax rules permits the donor to stretch the benefits of his (her) gifting program.

#### Some Reasons for Gifts

The primary reason for a program of gifting is to benefit family members. When most of the assets are owned by one spouse, a substantial gift equalizing the family assets is a statement of trust (in some families, however, a cultural tradition of transferring land only along blood lines complicates this process). Gifts to adult children, especially of forest land, may promote a sense of financial maturity in the donees and motivate them to learn how to manage the forest land. In this way, the donor can see the responsibilities for managing a going concern transferred to the next generation with efficiency and effectiveness. Other beneficial effects that can follow as a result of gifting are discussed in chapters 6 and 9.

Gifts from senior family members who are in higher income tax brackets can reduce the total family income tax burden by moving income-producing property into the hands of family members in lower income tax brackets. Charitable gifts provide an income tax benefit while at the same time benefiting charitable organizations that are personally important to the donor such as churches, colleges, museums, and others. By decreasing the size of the donor’s gross estate, gifting reduces both Federal and State death taxes; it also lowers estate settlement costs and avoids delays and probate fees on the gifted property. In some cases, the transfers can put the property out of reach of creditors.

Because of its power to reshape the donor’s estate, a program of gifting should be pursued cautiously. There also are disadvantages, the most important of which is loss of control of the gifted asset. Gifts of income-producing assets reduce the donor’s income; thus, important business entities

and key parcels of forest land may not be the best candidates for gifts. A gift also transfers the donor’s basis to the donee, with possibly adverse income tax results that would not be the case with a testamentary transfer. Additionally, special use valuation (see chapter 12) is not available for lifetime gifts of forest land.

#### Gifting Tax Considerations

There is a single, unified tax rate schedule that applies to both lifetime gifts and estates of decedents (see table 3.1). An applicable credit amount for gifts of \$345,800—providing an applicable exclusion amount of \$1 million—was established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; Public Law 107-16). The gift tax exclusion is not indexed for inflation; once the total of a donor’s taxable lifetime gifts reaches \$1 million, any excess is taxed at rates that currently range from 41 to 45 percent. Under EGTRRA, gift tax liability for years after 2009 will be determined using the same rate schedule as is used for the Federal income tax, with a maximum rate of 35 percent.

The goal of minimizing gift and estate taxes has been made more difficult by recent changes in the tax laws. For example, Clifford and spousal remainder trusts no longer can be used as effective income-splitting devices. These short-term trusts with reversionary interests of income or principal were used to shift income from the grantor to beneficiaries in lower tax brackets; such income now is taxed to the grantor, eliminating the benefit of these types of trusts. The so-called “kiddie tax” affects gifts to children under age 19 because their unearned income over \$1,800 per year (2008, as indexed) is taxed at the parents’ top rate (children 19 years and older with unearned income of \$900 or more (2008)) and claimed as dependents on their parents’ returns are taxed at their own rate). This provides a considerable incentive to increase an older child’s income with income-producing gifts.

Any transfer of property or an interest in property, without adequate and full consideration in money or in kind, may involve a gift.



## Incomplete Gifts

Gifts with no strings attached are complete gifts. A complete and bona fide gift requires a competent donor and donee, a clear intent to make a gift, an irrevocable transfer of legal title, the delivery of the gift to the donee, and the donee's acceptance. If a donor retains an interest in or power over the property gifted, it results in the gift being incomplete.

Incomplete gifts are more likely to occur in transfers to trusts than in outright transfers (see chapter 9). If provisions are included in a deed to the effect that, "if I outlive you, the property will become mine again," the gift is called "the possibility of a reverter." The gift is considered complete, but the restriction reduces its value. Along similar lines, a parent who gives the family forest land to the children, but tells them, "I plan to live here and hunt and fish until I die," has made a gift of a remainder (future) interest. Again, the gift is considered complete, but its value has been reduced and it is not eligible for the annual exclusion discussed below.

Gifts of property are valued as of the date of the gift. Any appreciation of the property while in the donee's hands is excluded from the donor's estate. In addition, gift taxes on property transferred more than 3 years before the donor's death are excluded from the donor's gross estate. Probate administration expenses on the value of the gift property and the gift taxes paid will be avoided, income from the gifted property will be excluded from the donor's estate, and State death taxes may be reduced in some States.

**Gifts of land and timber rights**—The Internal Revenue Service (IRS) treats a gift of underlying land with retention of timber rights by the donor as an incomplete gift. This means that the value of the land will be included in the donor's estate. Revenue Ruling 78-26, 1978-1 CB 286, held that the entire value of forest land given to an individual by a donor who reserved all timber rights for 10 years—which constituted personal property under the law of the State in which the timber was located—with the donor dying during the 10-year period without having removed any timber, was included in the decedent's gross estate. The United States Fourth Circuit Court of Appeals has upheld the IRS position, holding that under South Carolina law, when a decedent transferred her land to a corporation in exchange for shares of its stock, reserving timber rights on a portion of the land for 2 years, she also reserved an interest in the soil necessary to nourish the timber growing on it. The Court ruled that to the extent the transfer to the corporation was not for adequate and full consideration, the forest land was includable in her gross estate as a gift with a retained life estate (*Estate of Graham, M.H. v. United States*, United States Court of Appeals, Fourth Circuit, No. 83-1068, September 30, 1983, 52 AFTR 2d 83-6449).

## Gift Tax Rates, Credits, and Exclusions

As noted above, a tax that currently ranges from 41 to 45 percent applies to lifetime gifts over an applicable exclusion amount of \$1 million. The amount of gift tax payable in any calendar year is calculated by applying the unified transfer tax rate schedule (see table 3.1) against cumulative taxable lifetime gifts. Any tax on previous gifts is then subtracted from this amount, as is any amount remaining of the \$345,800 applicable credit amount for gifts.

Section 2504(e) of the Internal Revenue Code (IRC) sets a 3-year statute of limitations for revaluation of lifetime gifts for gift tax purposes. Under pre-1997 law, most courts permitted the IRS to redetermine the value of a gift for which the statute of limitations had expired, in order to determine the appropriate tax rate bracket and credit amount for the estate tax. Under current law, gifts may not be revalued for estate tax purposes if the statute of limitations for gifts has expired [IRC section 2001(f), as amended by the Taxpayer Relief Act of 1997 (TRA; Public Law 105-34)]. After exhausting all administrative remedies, a donor now may petition the Tax Court for a declaratory judgment as to the value of a gift.

Four gift tax exclusions currently apply: (1) the marital deduction; (2) the charitable deduction; (3) an annual exclusion for gifts to donees other than one's spouse; and (4) exclusions for qualifying payments of tuition and medical expenses.

**Marital deduction**—The marital gift tax deduction is an unlimited deduction for gifts to a spouse, provided under IRC section 2056(a). To qualify, a gift must satisfy four requirements: (1) the man and woman must be married at the time the gift is made; (2) the donor spouse must be a United States citizen or resident; (3) the donee spouse must be a United States citizen; and (4) the gift cannot be a "nondeductible" terminal interest unless in the form of a qualified terminal interest property (QTIP; see chapters 6 and 9 for discussion of QTIPs and chapter 9 for a discussion of terminal interests). There is no reporting requirement for an outright gift to a spouse.

The gift tax marital deduction is an effective planning tool in the right circumstances, but there is a question as to the extent it should be used. A lifetime transfer saves estate administration and probate expenses if the donor spouse is the first to die, and may permit full utilization of the applicable credit amount if the donee spouse dies first. As with all gifts, however, the donee's basis in the gifted asset is the same as the donor's; there is no "stepped-up" basis as with a transfer at death, which may result in adverse income tax affects. The QTIP election (see chapters 6 and 9) can be used if the donor feels it is necessary to ensure that the

children ultimately receive the property. These decisions should be analyzed carefully with expert counsel and with the family's goals fully in mind.

**Charitable deduction**—Like the marital deduction, the charitable deduction is an unlimited exclusion for gifts to qualifying charitable organizations, provided under IRC section 2522. Qualifying organizations include units of Federal and State government; units of local government (for gifts used exclusively for public purposes); religious, charitable, scientific, literary, or educational organizations; fraternal societies (for gifts used exclusively for religious, charitable, scientific, literary, or educational purposes); and veterans' organizations incorporated by an act of Congress. Even though they are not taxable, gifts that exceed the annual exclusion for gifts (below) must be reported on IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (see appendix III).

Charitable gifts generally also qualify for a deduction on the donor's Federal income tax return. A Federal gift tax return must be filed, however, in order to deduct any amount of a charitable gift that exceeds the annual exclusion.

**Annual exclusion for gifts**—An annual exclusion for gifts to donees other than one's spouse is provided under IRC section 2503(b). TRA indexed the exclusion for inflation with adjustments made in \$1,000 increments; it currently (2008) is \$12,000. A donor may make excludable gifts to as many donees as he (she) desires each year, and a married couple may make "split gifts" that combine their individual exclusion amounts, even if only one has income (see below). The value of all gifts given to a donee during the year count against the exclusion amount, with non-cash gifts measured in terms of their fair market value.

To qualify as excludable a gift must be of a present interest; gifts of a future interest are not excludable. As long as a gift is made outright, the annual exclusion should not present a problem. With forest land, however, a qualified appraisal is necessary to verify the fair market value of the transfer.

**Example 8.1.** Parents have four adult, married children. One parent—in this case the mother—owns 2,000 acres of forest land in fee simple (outright), which has a fair market value of \$1,000 per acre. The annual exclusion for gifts allows the mother (donor) to give each child (donee) \$12,000 in value each year, tax-free. She can do this by giving each child either 12 acres outright or a \$12,000 undivided joint interest in the forest land (see chapter 14), for a total value of \$48,000 per year for all four children. She also can give each child's spouse 12 acres or a \$12,000 undivided joint interest in the forest land each year. The gifts could be made in the form of ownership of 24 acres or a \$24,000 family undivided

joint interest to each child and spouse, for a total value of \$96,000 per year for all four couples. It would take 21 years to transfer the entire holding in this way ( $\$2,000,000 \text{ forest land value} \div \$96,000 \text{ gift transfers per year} = 20.83$ , or 21 years).

**The Hackl case**—The present interest requirement recently surfaced in a tree farm gifting case [*Hackl, A.J., Sr. v. Commissioner*, 118 TC 279 (March 27, 2002); affirmed 2003-2 USTC ¶60,465, 335 F3d 664 (CA-7)]. Here the taxpayers gave their children and grandchildren membership units in Treeco, a limited liability company formed to hold and operate tree farming properties. When the properties were first purchased, they had little or no existing merchantable timber, but were bought to provide investment diversification in the form of long-term growth and future income. No timber had yet become merchantable when the gifts were made, and no income distributions were anticipated for many years. The Tax Court agreed with the IRS that because the gifts failed to confer substantial present economic benefits by reason of use, possession or enjoyment of the property, or income from it, they were gifts of a future interest and did not qualify for the annual exclusion.

**Tuition and medical expense exclusions**—IRC section 2503(e) provides an unlimited exclusion for qualifying gift payments of tuition or medical expenses. The exclusion for tuition applies to tuition paid to a qualifying educational organization. Only gift payments for direct tuition costs are excludable; payments for books, supplies, dormitory fees, board, or other education-related expenses cannot be excluded. The payments must be made directly to the educational organization on behalf of the student, not to the student.

The exclusion for medical expenses applies to payments to a provider of medical care that are not reimbursed—or reimbursable—by insurance. Qualifying expenses include those for diagnosis, cure, mitigation, treatment, or prevention of disease; affecting any structure or function of the body; transportation primarily for and essential to medical care; and medical insurance. Again, the payment must be made directly to the provider of medical care or medical insurance, not to the patient.

The donor need only note gift payments of tuition or medical expenses on their Federal income tax return. There is no other reporting requirement.

**Reporting procedures**—Except as just noted, a gift tax return, IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (see appendix III), must be filed for transfers of cash or property greater than the annual exclusion for gifts and for split gifts (see below), regardless of value. The gift tax return is due on April 15 (or

as extended) of the year following the year the gift is made, together with the Federal income tax return for the year of the gift.

**Other considerations**—Only a handful of States still have a gift tax on transfers of property. For donors residing in one of these States, this should be a consideration in making gifts (see chapter 18).

### Split Gifts

If both spouses agree, a married couple can make a gift to a child or any other person and treat the transfer as though one-half had been made by the husband and one-half by the wife. The couple can make such a gift even if it comes from income earned or an asset owned entirely by one of them. The gift is “split” for the purposes of computing the gift tax, and thus is taxed at a lower rate than if the entire gift had been given by one spouse. The \$12,000 annual exclusion (2008, as indexed) and applicable credit amount are applied jointly, but the actual donor must file the gift tax return.

**Example 8.2.** Assume the same facts as in example 8.1, but now the father (who has no ownership in the forest land) agrees to make split gifts to the children. The parents now can give each of the four children up to 24 acres or a \$24,000 undivided joint interest in the forest land each year. They also can make split gifts to each child’s spouse, bringing the total amount gifted to each couple to 48 acres or a \$48,000 undivided joint interest in the forest land each year. This would bring the total amount gifted to \$192,000 per year, requiring just 11 years to transfer the entire holding ( $\$2,000,000 \text{ forest land value} \div \$192,000 \text{ gift transfers per year} = 10.42$ , or 11 years). One way to make the transfer would be to simply draft a deed for each couple for 48 acres in joint ownership.

Spousal split gifts are allowed only if: (1) both the husband and wife are United States citizens at the time the gift is made; (2) the couple is married at the time; and (3) they agree to split all their gifts for the calendar year.

### Basic Gifting Strategies

This section focuses on the economic impact of giving an asset; the effective use of the applicable exclusion amount, annual exclusion, marital deduction, and gift-splitting; and the relative advantages of using cash or its equivalent as the gift property. Forest land is emphasized, but other assets usually found in forested estates are included.

### What Type of Property to Give

A gift can take any number of forms, for instance: (1) personal property such as art, cash, business interests, securities (stock), personal effects, cars, or other tangible assets; (2) real estate such as rental property, forest land, timber and hunting leases, personal residences, easements, or other rights in real property; or (3) life insurance, including cash value, cash refunds, or other benefits associated with the policy. Of course, selection of the type of gift should be meshed with the overall estate planning goals.

Here are some basic considerations to bear in mind in choosing gift property.

**Low gift value**—For lifetime gifts, it makes sense to give property that has low gift tax cost but high potential estate tax cost. Appreciating assets, such as forest land in premerchtable and young-growth timber, fit this category (see the trust example in chapter 9). Forest land with high growth potential is a good candidate for gifts because it can become an estate tax problem for the donor if held.

**Appreciated property**—Forest land often fits into the appreciated property category. The strategy is to move ownership from an individual in a high income tax bracket to one in a lower bracket. Note, however, that it may be better for income tax purposes to retain appreciated property until the decedent’s death in order to get a stepped-up basis. In making this choice, compare the savings associated with low income tax brackets with the high-bracket estate tax.

**High-yield assets**—Senior family members in the 35-percent income tax bracket may consider transferring high income-producing assets to children (over 18) who are just getting started in their careers and are in a lower bracket. Alternatively, a retired parent in a lower income tax bracket should consider gifts to middle-aged children of low income-producing assets with good growth potential such as rapidly appreciating young stands in premerchtable and young-growth timber.

**Keeper assets**—Forest land often is low-basis property that will remain in the family. Senior family members who worry about control of their forest land often consider transferring the land to the children while retaining the timber rights. Since this can cause future estate tax problems, the donor could harvest the mature timber and transfer the cutover bare land. This transfer can be coupled with gifts from liquid resources to cover the cost of reforestation. In this case, it is important to make sure the donees have the resources to handle the management costs and carrying charges associated with the property before the timber grows to merchantable size.



**Problem property**—If forest property with growth potential will cause problems for the donor’s executor if retained because it is difficult to value, sell, or divide, the owner should gift it during his (her) lifetime. The family home, the lake property, or the vacation cottage typically fall into this category, as do art, antique guns and clocks, and jewelry.

**Jointly held property**—If forest land is held jointly, it may be advantageous to retitle the property to make it easier to handle for testamentary disposition. For example, if a parent and child own forest land jointly, the parent may wish to gift his (her) interest to the child. This avoids the problem of having the property fully valued in the estate of the first to die due to inadequate records for proof of proportionate contributions.

**Life insurance**—It may be beneficial to transfer ownership of a life insurance policy to a junior family member or to a life insurance trust (see chapter 10). The transfer may trigger a gift tax based on the replacement value of the policy, but will prevent the policy’s full face value from entering the donor’s estate.

### Income Tax Basis

A donee’s basis in gifted property is the donor’s basis, plus any gift tax paid on the net appreciated value of the gift while owned by the donor. For this reason, highly appreciated property often should be held, so the donee can benefit from the step-up in basis that occurs with a transfer at death. This strategy, however, must be balanced against the potential for further appreciation in the value of the property.

### Installment Sales and Gifting of Installment Notes

The strategy of selling property to a relative such as a child under an installment contract and then forgiving all or part of the payments as they come due should be used with considerable caution. This strategy runs the risk of having the sale re-characterized as a gift. A possible solution is to accept the payments—treating them as income for tax purposes—then make gifts of cash to the child, who can deposit the gifts into a separate account from that used to make the payments (see chapter 11).

### Gifts to Minors

Gifts within families are the most common type of lifetime gifts, such as gifts from parents to children and from grandparents to grandchildren. Many gifts to minors are made without much thought to the legal or

tax consequences. As long as such gifts are small, there generally is no serious problem.

As gifts increase in value, however, the so-called “kiddie tax” (discussed above) can have an impact on minors under the age of 19. State law often is concerned about protection of a minor’s rights and their legal capacity to own, manage, and sell property. Many States require a guardian for a minor who owns real property, place restrictions on a minor’s power to make contracts, and otherwise restrict a minor’s ability to conduct business on his (her) own behalf. These constraints complicate gifting to minor children, especially gifting of real property such as forest land. Vehicles such as trusts, custodianships, and guardianships are used to protect the interests of minors. These differ in important ways, and their advantages and disadvantages should be understood before starting a substantial gifting program involving minors.

Two pieces of legislation have been widely adopted which make the process of gifting to minors more uniform across States. The Uniform Gifts to Minors Acts (UGMA) and more recently the Uniform Transfer to Minors Acts (UTMA) have made it easier and safer from a legal standpoint to make gifts of all types of property to minors.

When making gifts to minors, the legal, tax, and practical management aspects of the transfer all should be considered, particularly where forest land is concerned. Recent tax acts have increased the spread between the lowest and highest noncorporate income tax brackets, which has perhaps increased the motivation for tax shifting. State income taxes also need to be considered.

**Example 8.3.** Assume that a parent who is in the 35-percent marginal income tax bracket gives a child who is over age 18 and in the 10-percent bracket an interest in forest land that is under a long-term lease to a forest products company. The interest provides an income of \$10,000 per year, which is treated as ordinary income for income tax purposes. Assuming the child has enough additional unearned income from other sources to use the standard deduction, the family has saved \$2,500 in income taxes [ $(\$10,000 \times 0.35) - (\$10,000 \times 0.10)$ ].

Parental obligations, however, must be taken into account. The legal obligation of support makes the child’s income attributable to support taxable at the parent’s rate; in addition, trust income actually applied to the support of a beneficiary whom the grantor is legally obligated to support is taxable to the grantor (IRC section 677). The IRS treats custodial accounts similarly, and many State laws treat a guardianship as a trust, which would subject it to treatment under IRC section 677. The definition of support under

State law should be considered carefully, since expenses for private schools, a college education, and in some cases, a graduate education may be required as proof of support.

### Custodianship

Under the UGMA and UTMA laws for transferring property to minors, custodians have the same power over the property that an unmarried adult exercises over his (her) own property. These laws permit all types of property to be transferred, including forest land, and the custodian can enter into business transactions that are needed to manage the property. Such actions, however, are subject to the laws governing fiduciary obligations.

State statutes should be checked for the specific requirements concerning transfers, for the exact responsibilities of the custodian and for the age of majority. The custodial control of a minor's property usually is given over to the full control of the donee at the age of majority, but the applicable State law should be reviewed.

**Estate tax**—If the minor child dies before the custodial account is transferred to his (her) control, the property is includable in his (her) estate. It also may be included in the donor's estate if the donor is the custodian and dies before the child reaches the age of majority. It is, therefore, not a good idea for the donor to serve as custodian and risk having the assets included in his (her) estate, especially if the value is large. There are similar problems with the donor's spouse serving as custodian—a reliable aunt, uncle, or cousin might be a better choice.

**Gift tax**—Gifts under the UGMA and UTMA laws qualify for the annual gift tax exclusion of \$12,000 (\$24,000 for split gifts). Parent-donors, however, should not be custodians because there is a risk that the transfer to the child-donee at majority could be treated as a release of a general power of appointment and, therefore, taxable to the parents.

### Guardianships

A legal guardian takes custody of and manages a minor's property. A guardian has fiduciary responsibility similar to a trustee; however, the guardian does not hold legal title to the property as does a trustee. The guardian can receive gifts for a minor.

**Example 8.4.** Assume the same facts as in example 8.3. The parent is appointed as the child's guardian and, in addition, is legally obligated for his (her) support. If used for the child's support, the \$10,000 annual lease income would continue to be taxed at the parent's 35-percent marginal tax rate even though it is now the property of the child. Any portion not used for the

child's support, but for his (her) benefit in other ways, is taxable to the child. The guardian files the income tax return for the child.

For estate purposes, the property that is given to the child is removed from the donor's estate, subject to the provisions for gifts within 3 years of death, discussed below.

A guardianship—which includes bonding, accounting, and court supervision—provides the greatest protection for the child's property rights. This extra measure of security for the child often means added operating costs and constraints on the flexibility of operations, as compared to a custodial or trust arrangement. Potential disadvantages include termination at majority, which may be earlier than is in the best interests of the child's welfare, and adverse estate tax consequences if the child dies within the term of the guardianship.

### Trusts for Minors

Trusts can provide a very flexible means of making large gifts. The general applicability of trusts as an estate planning tool is addressed in chapter 9; certain specific issues related to gifts to minors are discussed here. The grantor of a trust has considerable freedom to design the trust instrument to meet his (her) objectives. A trust can be established to distribute income to a minor during its term, accumulate income for the minor, or both. The grantor can establish the term of the trust, select the trustee (and the successor trustee), specify when and how the principal will be distributed, and fulfill other functions discussed in chapter 9. If the size of a gift warrants the expense of setting up and operating a trust, it probably is the most effective way to transfer the gift to a minor.

Two basic types of trusts commonly are used to make gifts to minors. Trusts written to conform to the provisions of IRC section 2503(b) make use of the annual exclusion for gifts possible, since the transfer is a gift of a present interest. This type of trust requires current distribution of income, but does not require distribution of the principal when the beneficiary reaches age 21. Trusts written in accordance with IRC section 2503(c) also permit use of the annual exclusion for gifts. In this case current distribution of income is not required, but distribution of the principal and accumulated income is required when the beneficiary reaches age 21—or sooner if specified in the trust instrument. The annual exclusion also is available if the beneficiary "may" use the income before he (she) reaches age 21, with the principal paid at 21. If the beneficiary dies before reaching age 21, the principal is paid to his (her) estate [*Gall v. U.S.*, DC Tex., 75-1 USTC ¶ 13,067 affirmed 75-2 USTC ¶ 13,107 (CA-5), 521 F2d 878 (1975)]. With these types of trusts, the income portion is considered a gift of a present interest and the

principal portion a gift of a future interest; the income tax treatment for the beneficiary is as discussed above.

A trust written under the provisions of the previous IRC section 2503(c) is a separate taxable entity. The income tax treatment of trusts is discussed in chapter 9. The trust property generally will not be included in the donor's estate.

Trusts have considerable flexibility as tools for making gifts to minors, but they require careful attention to draftsmanship in order to ensure they qualify for the annual exclusion for gifts and also make practical sense for management of property such as forest land. A qualified estate planner should be consulted.

### Gifts within 3 Years of Death

The value of a gift made within 3 years of death generally is not includible in the donor's estate. Such gifts are valued on the effective date of transfer, and the appreciation in value after that date is not subject to the Federal estate tax.

There are certain exceptions to this rule, however, which apply whether or not a gift tax return is required. The value of a life insurance policy transferred by the decedent within 3 years of death is included in the gross estate (IRC section 2036). In addition, all gift transfers within 3 years of death are included in the calculation of estate value for purposes of determining whether the estate qualifies for special use valuation under IRC section 2032A (see chapter 12), deferral and extension of tax payments under IRC section 6166 (see chapter 13), and qualification for special stock redemptions (IRC section 303). Such gifts do not, however, assist in meeting the statutory percentage requirements under these statutes. In addition, gift taxes paid on gifts within 3 years of death are includable in the donor's estate.

Despite these restrictions, there still are good reasons for proceeding with a gifting program within 3 years of death. As noted above, the appreciation after the gift's transfer is not taxable to the donor; therefore, properties with high appreciation potential such as plantations of premerchantable and young-growth timber (see discussion in chapter 2) are good candidates for gifts. Similarly, income generated from the gift once it is made is not includable in the donor's estate. For spouses, the unlimited marital deduction may be used without incurring a gift tax. Gifts to donees in lower income tax brackets may save on income taxes if they are not subject to the "kiddie tax." In States with a gift tax, the State gift taxes paid are deductible on the Federal estate tax return.

Certain negative factors must be considered in making gifts within 3 years of death. One is the gross-up provision,

which takes all previous taxable transfers into account when computing the transfer tax. Also, as discussed above, the gift does not get a stepped-up basis as does a testamentary transfer. This is disadvantageous particularly for forest land because timber is a long-term investment and the basis for most timber assets held for a long period is low.

## Charitable Gifts

### Overview

After one's spouse and children are adequately provided for, a plan for charitable giving of additional assets can bring great personal satisfaction. A donor can benefit his (her) family and the charity in a variety of ways. The affordability of the gift depends on its after-tax cost, which is affected by the donor's filing status, taxable income and the sum of Federal, State, and local taxes, as adjusted.

### Charitable Income Tax Deduction

Taxpayers generally can deduct contributions to religious, charitable, educational, scientific, and other organizations from income taxes. Tax effects depend on *when* assets are given, *how* they are given, *how much* is given, and to *whom* they are given. For substantial gifts, the donor should understand the different categories of charitable giving, which include: (1) public charities such as churches, universities, hospitals, and foundations that receive considerable public support; (2) semipublic charities such as veterans' organizations, nonprofit cemetery associations, and others that do not fit into a the public charity category; (3) private charities such as private, nonoperating, or distributing foundations; (4) contributions for the use of a charity (rather than "to" a charity); and (5) capital gain property—that is, highly appreciated property.

Churches and units of government are automatically viewed as charitable, but private organizations must meet the requirements of IRC section 501(c)(3) and have on file an "exemption letter" from the IRS to prove their status in order to assure a tax deductible contribution.

The percentage limitations on charitable contributions deductions are based on the category of the organization and the nature of the gift. The charitable contribution deduction for the tax year is limited to a percentage of the donor's "contribution base," defined as his (her) adjusted gross income without regard to any net operating loss carry back.

A 50-percent limitation on charitable deductions applies jointly to so-called "50-percent" charities, which include several organizational categories, public and private. The limitation is applied first to public charities, then to private

charities, with any excess contributions carried over for five succeeding tax years. There is a 30-percent limitation on deductions to private charities classified as so-called “30-percent” charities as well as on contributions “for the use of” charities. Examples of the former include fraternal orders and veterans’ organizations. Deductions for contributions of capital gain property to semipublic and private charities are limited to 20 percent of the donor’s contribution base. There also is a special 30-percent limit on certain capital gain property given to a public charity, and there are further limitations based on the ratios among the various categories.

**Valuation of contributions**—A deduction for donated property is measured by its fair market value, subject to certain reductions for appreciated property as discussed below. No problems exist for securities that are publicly traded; for large gifts of real estate or forested property, however, a qualified appraisal must be obtained and a summary of it attached to the tax return (IRS Form 8283, Noncash Charitable Contributions, Section B) if the value of the property exceeds \$5,000 (\$10,000 for non-publicly traded property). The appraisal must be made within 60 days prior to the date of the gift and the appraiser must be qualified to make appraisals of the type of property being gifted. For example, forest land should be appraised by a person who meets the Federal appraisal standards. The appraiser must sign the form, must not be related to the donor, and must not work on a percentage basis. There are penalties for overvaluation of property. If an audit determines the reported value to be 200 percent more than the correct value, a 20-percent penalty can be imposed. Additional penalties can be levied for more blatant overvaluation.

**Appreciated property**—The charitable deduction depends on the property’s fair market value, the type of property (real or personal), the holding period, the character of the charity, and the use of the property. Capital gain property and ordinary income property retain their different characters for charitable purposes.

Capital gain property held by the donor for more than 1 year is given favorable tax treatment; the donor gets a deduction of fair market value and does not have to pay tax on the appreciation, subject to the alternative minimum tax (AMT). For real estate, including forest land, the donor is entitled to a deduction based on the property’s fair market value on the date of the contribution. The deduction generally is limited to 30 percent of the donor’s contribution base, as noted above, if made to a public charity such as a church or university. If the contribution goes to a semipublic charity the limitation drops to 20 percent. Contributions of capital gain property to certain private foundations that do not make distributions may be limited to the property’s basis.

There also is a special rule on contributions of appreciated property that permits the donor to deduct up to 50 percent of his (her) contribution base if an election is made to reduce the value of the contribution by the amount of the appreciation. The decision whether to make this election should be based on the amount of the appreciation (forest land often has a very low basis and may not be a good choice), the importance of a deduction greater than the 30-percent limit, and the donor’s exposure to the AMT provisions of the Federal income tax. Value appreciation is a preference item that is included in the base of AMT taxable income.

### **Charitable Estate Tax Deduction**

Lifetime charitable contributions generate not only an income tax deduction but also an estate tax deduction that depends on the marginal estate tax rate. At the estate’s current taxable threshold (that is, over \$2 million in taxable value) the saving would be 45 percent of the value of the charitable contribution. If the transfer is a testamentary bequest or is includable in the donor’s estate by virtue of a retained interest, only the estate tax deduction will be available.

### **Gifts with Retained Interest—Charitable Remainders**

A forest landowner may be thinking of giving a particular property to a charity, but may need the income from the property. The transfer could be made at death, but there may be a spouse or other family member who might need the benefit of the income after the donor is gone. For example, many parents who own forest land in rural, often remote areas of the country have children who live in distant cities and often have little interest in the forest land. The children, however, may feel that they might need the income from the property for educating their own children or for some other reason.

Landowners in this situation can make a present gift to a charity of a future interest, known as a charitable remainder. If the gift is money or liquid assets, the transfer should be in trust. For real property, however, the remainder interest can be created without using a trust. The remainder can be constructed to take effect at the end of a set term of years, at the donor’s death, on the death of the surviving spouse, or on the death of other persons. There are, of course, some strict limitations.

The present value of the remainder interest is deductible for Federal income and gift tax purposes, if given to a qualified charity. The amount of the gift is the fair market value of the property, less the value of the retained “life interest,” as determined from actuarial tables.



**Charitable remainder trusts**—The donor can get an income, estate, or gift tax deduction for a charitable contribution to a charitable remainder trust that has one or more non-charitable beneficiaries only if the trust qualifies as an annuity trust or a unitrust under the IRC. An annuity trust provides a “fixed annuity payment” to the income beneficiaries, while a unitrust provides a “variable annuity payment” based on a percentage of the trust’s earnings. Both types of trusts can be established during a donor’s lifetime or by the donor’s will. The donor is required to set aside certain assets with payments—either fixed or variable—made for either a fixed term (not to exceed 20 years) or for the life of the donor-grantor, his (her) spouse, or other named person(s) with the remainder to go to a qualified charity. Distributions to the beneficiaries must be made at least annually, and the principal must not be used for the beneficiaries’ benefit except in accordance with specific payout requirements in the trust.

Both the annuity trust and the unitrust require a payment rate of at least 5 percent. The payment under an annuity trust is calculated on the basis of the initial fair market value of the trust assets, updated annually. With a unitrust, the beneficiaries have a variable annuity. For example, if the assets are forest land, the payments may fluctuate with the cyclical nature of the timber market. With a unitrust, the instrument may—but is not required to—have a provision permitting use of the principal if the annual income is insufficient. Furthermore, additional contributions can be made to a unitrust during the grantor’s life or by the grantor’s will under specified terms and conditions [Treasury Regulation 1.664-3(b)]. With an annuity trust, once the payment schedule is established, the annual payments are made from principal if current earnings are insufficient, and no additions to the trust are accepted. If the payment rate is set too high for an annuity trust, the remainderman—the charity—may get a smaller gift than expected or none at all. This situation has been noted as an opportunity that invites abuse and thus has merited IRS and congressional attention.

The unitrust may be created with an income-only or makeup option. Under this arrangement, the trustee pays the beneficiary only the current income, but as earnings increase in future years any deficit in previous payment amounts is made up [IRC section 664(d)(3)].

**Tax consequences**—For tax purposes, the remainder interest under an annuity trust is the net fair market value of the trust property, less the present value of the annuity. If two or more beneficiaries are involved, the computations are based on the life expectancies of each. The present values are computed using the IRS tables in IRC section 7520 and are based on a floating interest rate equal to 120 percent of the midterm Applicable Federal Rate. Examples of the procedure can be found in IRS Publication 1458, Actuarial Values.

The annuity trust and the unitrust are exempt from Federal income taxes except for unrelated business taxable income. Distributions to trust beneficiaries are taxed first as ordinary income, then as a capital gain to the extent of the trust’s undistributed capital gains. For estate tax purposes, the trust property’s value will be included in the grantor’s estate if he (she) is the sole beneficiary.

**Pooled income fund**—This is an IRS-designated vehicle for charitable contributions that meets a donor’s needs and provides him (her) with a tax deduction, while operating within safe guidelines for valuation of the contributions and for the protection of the government and the charity. Whereas the annuity trust and unitrust are private endeavors, pooled income funds pull together several contributors to benefit both the charity and the individual contributors. In a word, a pooled income fund is a public trust that is controlled by the charity. Most of the provisions are similar to the annuity trust and the unitrust; however, with pooled income funds, the property of all donors is commingled. A pooled income trust cannot receive or invest in tax-exempt securities. The income tax deduction is based on the present value of the remainder interest to the charity.

**A charitable lead trust**—This is the reverse of the charitable remainder annuity trust. Property is left to create “income” for the charity, with the remainder interests passing to the family. A charitable lead trust reduces death tax liability; however, there may be a gift tax on the present value of the remainder interest when the trust is created.

**Charitable remainder in a personal residence or farm**—Generally, a donor can obtain a charitable contribution deduction for a gift of a future interest in property only through a charitable remainder trust or a pooled income fund. The IRC makes an exception, however, for a gift of a farm or personal residence [IRC section 170(f)(3)(B)]. Under these circumstances, a donor can contribute the property to a charity, but reserve the right to live on it or use it for the rest of his (her) life and the life of the surviving spouse, if applicable. The gift must be irrevocable.

The personal residence can be a second home or cooperative apartment. A “farm” means land improvements used by the donor or tenant to produce crops, fruits, or other agricultural products of livestock or poultry [Treasury Regulation 1.170A-7(f)(4)]. The regulation does not explicitly include or exclude forest land, so if a taxpayer is considering using this provision for forest land, it would be prudent to obtain a private letter ruling (see chapter 5) from the IRS. If this fails, other alternatives should be considered. For example, this type of asset can be transferred by deed during life or by will at death, with the surviving spouse having income and right of possession for life, and the property then passing to the charitable organization at his (her) death.

## Qualified Conservation Contribution

A charitable contribution of an interest in property that is less than the donor's entire interest does not qualify for a deduction unless it is an undivided part of the donor's entire interest, or a gift of a partial interest in property that would have been deducted if it had been in trust.

A charitable contribution of an open space easement in gross and in perpetuity is treated as a contribution of an undivided portion of the donor's entire interest in the property [Treasury Regulation 1.170A-7(b)(1)(ii)]. An easement in gross is defined as a personal interest in, or right to use, the land of another. A deduction is allowed for the value of a restrictive easement gratuitously conveyed to a qualified charitable organization (see below) in perpetuity. Special rules apply to easements and remainder interests for conservation purposes.

Gifts of partial interests in real property generally do not qualify for a charitable contribution deduction; a qualified conservation contribution, however, is an exception [IRC section 170(f)(3)(B)(iii)]. A qualified conservation contribution is defined as a qualified real property interest donated to a qualified conservation organization exclusively for conservation purposes [IRC section 170(h)]. A qualified real property interest is defined as the entire interest of the donor other than a qualified mineral interest, a remainder interest, or a restriction granted in perpetuity on the use that may be made of the real property. The term "conservation purpose" is defined to include any one (or more) of four objectives: (1) the conservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the conservation of open space (including farmland and forest land) where such conservation will yield a significant public benefit and either (a) is for the scenic enjoyment of the general public, or (b) is pursuant to a clearly delineated Federal, State, or local governmental conservation policy; or (4) the conservation of a historically important land area or a certified historic structure.

The conservation purpose must be protected in perpetuity. Qualified organizations are limited to government and publicly supported charities or organizations they control. The value of the conservation easement is based on the sales of similar easements if such records exist. If such records do not exist, the conservation easement is based on the difference between the fair market value of the property before and after the easement. Thus, valuation of the charitable deduction of a conservation easement generally is accomplished by subtracting the value of the property as encumbered by the real property interest from the value of the property determined without regard to the transfer

of the qualified real property interest [Treasury Regulation 1.170A-14(h)(3), Revenue Ruling 73-339, 1973-2 C.B. 68]. After the conservation easement is made, the donor must reduce the basis of the retained property by the proportional part of the basis allowable to the easement.

In connection with the exclusivity requirement, the regulations also provide that a deduction will not be allowed if the contribution would in fact accomplish one of the enumerated conservation purposes, but would additionally permit destruction of other significant conservation interests. This requirement is not intended to prohibit uses of the property such as selective timber harvesting or selective farming, if under the circumstances, those uses do not impair significant conservation interests [Treasury Regulation 1.170A-14(e)(2)].

### Subsequent transfers by conservation organization

The instrument of conveyance must prohibit the donee from subsequently transferring the qualified real property interest (the easement) unless the subsequent transferee is itself a qualified organization and the donor requires its transferee to carry out the conservation purpose. If unexpected changes in the condition of the area surrounding the property make the continuation of the conservation purpose impossible or impractical, the qualified real property interest may be sold if the proceeds of sale are used by the donee in a manner consistent with the conservation purpose of the original transfer.

**Income tax deduction rules**—The income tax deduction rules for charitable contributions discussed earlier in this chapter also generally apply to gifts of conservation easements. Current law, however, provides additional incentives for qualified conservation easement contributions. The Federal income tax deduction for such contributions is increased from 30 percent to 100 percent of adjusted gross income (AGI) for qualifying farmers and ranchers, and to 50 percent of AGI for other individual taxpayers. In addition, the carryover period for unused contributions is extended from 5 years to 15 years for both groups. Qualifying farmers and ranchers are those whose gross income from farming or ranching exceeds 50 percent of their total gross income. These provisions were provided initially by the Pension Protection Act of 2006 (Public Law 109-280) for 2006 and 2007, but were extended to 2008 and 2009 by the Food, Conservation, and Energy Act of 2008 (Public Law 110-246). As of this writing, they are scheduled to expire after December 31, 2009.

**Example 8.5.** Tall Pine owns a 200-acre parcel of forest land in the path of a suburban leapfrog development. The property has been in the family since the original land grant, and Pine's objective is to keep the property in the family and in timber production. The use value

of the property for timber production is \$400,000 including the current growing stock which has been well managed for timber and wildlife. The fair market value in the “highest and best use” is \$900,000.

In 2007, Pine gave the U.S. Department of Agriculture Forest Service a permanent conservation easement subject to the restrictions that the property be managed on a sustainable basis, with no more than 20 percent of the timber harvested in any 5-year period and harvested areas regenerated within 2 years. The \$500,000 (\$900,000 – \$400,000) charitable contribution is subject to the income tax rules discussed above; the income tax charitable deduction is limited to 50 percent of adjusted gross income. Since Pine’s adjusted gross income is \$250,000, the current income tax deduction is \$125,000 ( $\$250,000 \times 0.50$ ). With a 15-year carry-forward period for excess contributions, Pine will deduct the remaining \$375,000 from future income, which in all likelihood will absorb the excess deductions. The estate’s value will be reduced by the \$500,000 encumbrance on the property. Pine’s appraisal was made by a qualified general appraiser and registered forester who works for a reputable consulting forestry firm.

**Estate tax exclusion**—Under TRA, the executor of an estate is allowed to exclude from the gross estate up to 40 percent of the value of any “land subject to a qualified conservation easement” [IRC section 2031(c)(1), as amended by TRA]. The exclusion is subject to certain limitations. If the value of the easement, reduced by the value of any retained development rights, is less than 30 percent of the value of the land without the easement, the 40 percent exclusion is reduced by two percentage points for each point that the ratio falls below 30 percent. For example, if the value of a conservation easement is 25 percent of the value of the land before the easement, reduced by the value of retained development rights, the exclusion percentage is 30 percent  $\{40 \text{ percent} - [2 \times (30 \text{ percent} - 25 \text{ percent})]\}$ . Under these rules, if the value of the easement is 10 percent or less of the value of the land before the easement, reduced by the value of retained development rights, the exclusion percentage equals 0. The exclusion limitation is \$500,000. The conservation easement may be in place before the donor’s death or it may be put in place after death by the estate executor with the approval of all heirs/legatees.

For debt-financed property, the exclusion only applies to the extent of the donor’s net equity in the property [IRC section 2031(c)(4)(A)]. Also, the exclusion does not apply to the value of any development rights retained by the donor in the conveyance of the qualified conservation easement. If, however, every person who has an interest in the land executes an agreement to extinguish permanently some or all of the development rights retained by the donor on or before the date for filing the estate tax return, any estate tax due is reduced accordingly; the agreement(s) must be filed with the estate tax return. An additional tax, in the amount of the tax that would have been due on the retained development rights subject to the agreement, will be imposed on any failure to implement the agreement not later than the earlier of: the date that is 2 years after the date of the decedent’s death, or the date of the sale of the land subject to the easement. For these purposes, the term “development right” means any right to use the land subject to the easement in which the right is retained for any commercial purpose that does not directly support use of the land as a farm for farming purposes, defined to include timber production.

**Exclusion election**—The election to exclude from the gross estate the value of land subject to a qualified conservation easement is made on the estate tax return. Once made, the election is irrevocable [IRC section 2031(c)(6)]. The term “land subject to a qualified conservation easement” means land that is located in the United States or a U.S. possession. The land must have been owned at all times by the decedent or a member of his (her) family during the 3 year period ending on the date of the decedent’s death [IRC section 2031(c)(8)(A)(ii)]. A member of the decedent’s family is defined as an ancestor; spouse; lineal descendent of the decedent or the decedent’s spouse, or of a parent of the decedent; or the spouse of any lineal descendent described above. The definition of “qualified conservation easement” generally is the same as that for a qualified conservation contribution for estate and gift tax deduction purposes, discussed above, with two exceptions: (1) the preservation of a historically important land area or a certified structure does not qualify, and (2) a perpetual restriction on the use of real property must include, for purposes of the estate tax exclusion, a prohibition on more than a de minimus use for commercial recreational activity. The exclusion applies to interests in partnerships, corporations, and trusts, if at least 30 percent of the entity is owned by the decedent [IRC section 2031(c)(9)]. To the extent that the value of land subject to a qualified conservation easement is excluded from the gross estate, the basis of the land acquired at death is its basis in the hands of the decedent; that is, the basis is carried over, not stepped up.





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## Chapter 9

### Role of Trusts

#### Overview

A trust is an arrangement by which a person or entity called the trustee holds legal title to designated property in trust. The property in the trust, called the corpus, is managed by the trustee for the benefit of one or more beneficiaries. The rules governing trust administration come from Federal law, State law, and the provisions of the trust instrument itself. Federal law primarily concerns the Federal tax treatment of income, estate, and gift transfers associated with trusts. State law generally governs the conduct and rights of the trustee, trustee action, and State tax aspects. The trust instrument contains the rules of operation within the options permitted by State law.

A trust may be established to do almost anything the person creating it, called the grantor or settlor, might do himself (herself) and some things that he (she) cannot do because of lack of skill, illness, disability, distance from the forest land, or death. The ability to bridge the gap between life and death is one of the remarkable characteristics of a trust. A trust is recognized as a separate legal entity from the grantor under both Federal and State law.

#### Basic Considerations

The discussion that follows concerns trusts generally; however, the principles are illustrated in several examples concerning forest land.

#### Trust Provisions

Trust law is complex and, as noted above, is based on both Federal and State law. Because the States do not have a uniform law of trusts, it is imperative to have the trust instrument drafted by an attorney who knows not only the Federal tax rules but also the applicable State law. The provisions generally included in a trust are:

**Property**—The property transferred to the trust to be managed—the corpus—is described. If forest land is being put in trust, the applicable deeds and legal descriptions should be included.

**Trustee**—This is the person or entity that holds title to the property and signs the trust agreement. The trustee may be

either an individual or an institution such as a bank, and may include co-trustees as necessary or desired.

**Beneficiaries**—Both primary and contingent beneficiaries may be named. The conditions under which income and principal will be distributed are spelled out. With respect to timber, it is particularly important to distinguish between the principal (the volume of merchantable timber and young growth present at the time the trust is created) and the income (subsequent growth), and between the trustee's powers and the beneficiaries' rights with respect to both.

**Powers**—The administrative powers and flexibility accorded the trustee are enumerated. Flexibility is important particularly with respect to forest land because of sometimes rapid changes in markets, technology, and regulations.

**Spendthrift Provision**—This bars transfer of a beneficiary's interest and stipulates that it is not subject to creditor's claims, but is subject to the provisions of State trust law.

**Term**—The term of the trust is its length. If a shorter period is not specified, State law limits the term of a trust under the "rule against perpetuities." Specific rules vary among States, but they generally specify a number of years following the death of the last surviving beneficiary or the last surviving settlor.

**Bond**—The trust may specify that the trustee post a bond, but most trusts exempt the trustee from this requirement. The bond provision also may address the conditions for exemption of successor trustees.

**Successor**—The trust instrument should provide for appointment of a successor trustee in the event the named trustee dies, declines to serve, or becomes incapable of serving.

**Fees**—Payment of reasonable fees to the trustee is provided for, or alternatively, the trustee serves without fee. Institutional trustees always serve for a fee.

#### Nontax Benefits

Nontax benefits can include professional management of financial and real property assets, including forest land. A trust can be designed to ensure a forest landowner or

beneficiaries of both income and protection from creditors. Trusts frequently are designed to benefit family members such as spouses, minor children and grandchildren, or aged parents.

A “living trust” is established during the life of the grantor and can extend beyond his (her) death; a “testamentary trust” is established upon an individual’s death according to provisions in his (her) will. The trust supplies the missing elements of management and experience for the beneficiaries, who may lack ability and training, be in poor health, be involved in school or a profession, or be incompetent. It can provide the opportunity to travel by ensuring professional management of forest land and other assets and by freeing the grantor and/or beneficiaries from management details. A trust ensures continuity of management, provides privacy, and can save probate expenses. In fact, trust creativity is limited only by the grantor’s imagination and the applicable law.

## Tax Treatment of Trusts

Trusts can provide savings in three major tax areas: income, estate, and gift. These are discussed here in general terms. Specific tax considerations associated with particular types of trusts are addressed below.

### Income Taxes

A trust can be either a separate taxable entity or a conduit for passing income to beneficiaries, who then report it on their own income tax returns, or it can be both. A trust can be set up to accumulate income, distribute income, or a combination of both; thus, the trust income can be split in one more way than there are beneficiaries, with the trust itself receiving a share. Grantor trusts, trusts with terms that cause the grantor to be treated as owner for income tax purposes, are excluded from the following discussion. The grantor of a grantor trust is taxed on trust income received, or trust income actually used for the support of someone who the grantor is legally obligated to support.

The Federal income tax savings associated with trusts have been limited severely by tax reform changes. Rules for short-term, income-splitting trusts such as Clifford and spousal remainder trusts (see chapter 8) have been changed; income from such trusts now is taxable to the grantor, eliminating them as effective devices for splitting income between grantor and beneficiary. Income from other types of trusts in excess of \$1,800 (2008, as indexed) per year received by children under age 19 who can be claimed as dependents on their parents’ tax returns is taxed at the parents’ rate of income. Federal income tax rate schedules for trusts and estates have been revised to bracketed

thresholds far below those of other noncorporate taxpayers. Also, trusts now must make estimated income tax payments; the current income tax rules on estimated payments and distributions to beneficiaries may increase the cost of trust administration. A number of ways remain for a trust grantor to retain favorable income tax treatment, but they require careful analysis by a specialist in order to conform to all the rules and are beyond the scope of this book.

**The trust tax return**—A trust is taxed like an individual with certain important exceptions. A limited exemption (equivalent to a personal exemption) of \$300 is allowed for trusts required to distribute all income currently, and \$100 for others. For the 2008 tax year, undistributed income is taxed at:

- 15 percent on amounts up to \$2,200
- 25 percent on amounts from \$2,200 up to \$5,150
- 28 percent on amounts from \$5,150 up to \$7,850
- 33 percent on amounts from \$7,850 up to \$10,700
- 35 percent on amounts over \$10,700

These thresholds are indexed annually for inflation.

In general, an estate or trust is limited to the 2 percent of adjusted gross income (AGI) floor on miscellaneous itemized deductions. Other deductions and credits for trusts also are similar to those for individuals, with some important differences for timber. For example, trusts are not eligible for the reforestation deduction of the first \$10,000 of qualified expenditures. As are all other taxpayers, however, they are eligible for amortization of all reforestation expenses over 84 months. The opportunity to immediately deduct certain depreciable costs under Section 179 of the Internal Revenue Code (IRC) also is not available to trusts. Other differences are covered in IRC section 642.

Generally, a simple trust operates on the conduit principle; the trust reports income received on its tax return, then is allowed a deduction to the extent it distributes or is required to distribute the income to beneficiaries. Beneficiaries are taxed on income required to be distributed to them whether they receive it or not. The distributable net income (DNI) concept defined in IRC section 643(a) limits the distribution deduction allowed the trustee, as well as the amount includable in the beneficiaries’ gross income.

**Example 9.1.** A simple timber trust requires that all income be distributed currently to the life beneficiary. For 2008 the trust has ordinary income of \$20,000 from crop and hunting leases, expenses of \$850 chargeable to income, \$3,000 in expenses chargeable to corpus, and a long-term capital gain of \$8,000 from timber sales (capital gains are excludable from DNI).

The beneficiary will receive \$19,150 (\$20,000 – \$850). The trust's DNI will be \$16,150 [\$20,000 – (\$850 + \$3,000)], which is the taxable amount to the beneficiary. The trust's taxable income is \$7,700 [(\$20,000 ordinary income + \$8,000 capital gain) – (\$300 exemption + \$3,850 in expenses + \$16,150 DNI)]. The result is that the trust beneficiary gets deductions that ordinarily would be charged to the trust principal.

Example 9.1 is for a simple trust. Complex trusts—which in addition to distributing income may accumulate income or distribute principal—are much more intricate and beyond the scope of this discussion.

The income tax basis for property transferred to a trust by a lifetime gift is the donor's basis, increased by any gift tax on unrealized appreciation. In contrast, property includable in a decedent's estate that is transferred from the decedent to a trust receives a "stepped-up" basis equal to its value for estate tax purposes. This is an important consideration in dealing with highly appreciated assets such as forest land. The stepped-up income tax basis for forested property that is valued in its current use under IRC section 2032 (see chapter 12) is its special use value.

**Accumulated income**—There are many reasons for accumulating income in a trust. For example, if the beneficiary does not need all of the trust income currently, or if he (she) could not use it wisely, it could be accumulated if the trust instrument permits. If the beneficiary's tax bracket is higher than that of the trust, the accumulation of income will produce an immediate tax savings; however, because the 25-percent tax bracket for trusts begins at \$2,200 (for 2008), the opportunity for this type of saving is severely limited.

When the trust accumulates income for high-income beneficiaries, certain so-called "throwback rules" apply to the ultimate distributions. The basic premise is that distributions are taxed at the rates in effect for the years the income was earned by the trust.

## Estate Taxes

When establishing a trust, the grantor must decide whether he (she) wants the trust corpus included in his (her) estate. If the estate will be subject to tax, there may be substantial estate tax savings from excluding property from the estate through a trust. There also are advantages gained from keeping the property out of probate, such as continuity of management and probate cost savings, which vary by State. The price of these benefits is loss of control of the property during the grantor's lifetime.

If the grantor is willing to permanently relinquish control of trust property, the property's value will not be included in his (her) estate. If the property is an insurance policy on the life of the grantor, however, he (she) must transfer it to the trust more than 3 years before death for it to be excluded from the estate (see chapter 8). Many grantors are reluctant to give up control even if it means large estate tax savings. Furthermore, tax problems often are associated with living trusts when it is not clear how much control or benefit has been retained by the grantor. Guidelines in a number of sections of the IRC should be observed to prevent the inclusion of trust assets in the grantor's estate.

**Powers**—If the grantor of a trust retains the power to revoke, alter, amend, or terminate a trust, the trust assets will be included in his (her) estate. Changes to the trust provisions to give up these powers should be made more than 3 years before the grantor's date of death (IRC sections 2035 and 2038).

**Life interest**—If a life interest in the possession, enjoyment, or right to income from the trust property or the power to dictate who will enjoy the property is retained, the property also will be included in the grantor's estate. For example, reserving the right to hunt and fish or the right to hunting lease income from forest land will result in the entire property being included in the grantor's estate. This rule also applies to voting rights associated with stock in a "controlled corporation" (see chapter 16), which may own timber in a trust.

**Reversionary interest**—Keeping a reversionary interest increases the possibility that property will return to the grantor's estate. If the reversionary interest is worth more than 5 percent of the total property value when the decedent dies, the property may be included in his (her) estate (IRC section 2036). An example of this type of transfer is where A creates a trust with the current income payable to B and the principal payable to C on the trust's termination, but with the provision that if C predeceases A, the principal is payable to A. Some States prohibit this type of trust altogether.

**General power of appointment**—Retention of the right to dispose of trust property in the grantor's favor, or in favor of his (her) estate or creditors, will result in the inclusion of the property in the estate (IRC section 2041).

**Insurance policy**—If an insurance policy is part of the trust corpus, the estate should not be the beneficiary, and if someone else is the beneficiary, the insured should not retain "incidents of ownership in the policy" (IRC section 2042; see chapter 10). Transfers of any powers with respect to an insurance policy within 3 years of death will result in the policy being included in the estate.

## Gift Taxes

A transfer of property to a trust involves a gift. The trust beneficiaries are the donees rather than the trustee. This fact has special significance in applying the annual gift tax exclusion. That is, there are as many annual exclusions available as there are beneficiaries for either the \$12,000 annual exclusion or the \$24,000 split gift tax exclusion (see chapter 8).

Transfers of non-income producing property to a trust also can pose a problem with the annual exclusion. Forest land generally is treated as being nonproductive when it does not produce current income. This problem can be overcome by showing that the timber is an appreciating asset that is producing unrealized income in terms of volumes and value growth. It may be advisable to incorporate growth projections and recommendations for producing periodic income by thinning and final harvests into the management plan. The information in the plan can be refined at any time to show current annual increments and a schedule of accumulating values. It also may be prudent to include a mix of other income producing assets with forest land to provide cash flow in any non-income producing year.

Trust benefits can be costly. The advantages outlined here must be balanced against costs such as legal fees, the trustee's fees, and ongoing forest management costs.

## Types of Trusts and Applications

Trusts are flexible tools in estate planning that can provide benefits that otherwise would be unavailable such as shielding assets from creditors' claims, accumulating college funds, and providing financial support for children or retired parents. Income or estate tax savings, or both, also may be a goal, as well as avoiding probate and the associated costs.

### Living Trusts

A living trust is created during the grantor's lifetime, and can either be revocable or irrevocable.

**Irrevocable living trust**—The grantor gives up the trust property permanently, but in return gains supervised management and investment of the assets and avoids probate on the trust property. He (she) may pay gift tax on the establishment of the trust (see chapters 3 and 8), but the trust corpus will not be includible in his (her) estate. Trust income is taxable to the beneficiaries as it is distributed. Other advantages of an irrevocable living trust include possible estate tax savings in the grantor's estate and in those of the life beneficiaries, providing protection for family assets, and perhaps income tax savings for the family. Avoiding probate also prevents public disclosure of the decedent's financial

affairs, the size of the trust assets, and the names of the beneficiaries and the property each received.

With respect to forest land, a trust eliminates the necessity of operating the forest as part of an estate while the estate is being settled. Savings are achieved on probate expenses and estate taxes by keeping the trust assets—which may have appreciated considerably since the trust was established—out of the grantor's estate. This is accomplished specifically by not retaining a life interest in the property (IRC section 2036); not keeping a reversionary interest worth more than 5 percent of the property value on the date of death (IRC section 2037); not keeping the power to alter, terminate, or revoke the trust (IRC section 2038); not having a general power of appointment as defined in chapter 6 (IRC section 2041); not possessing any incidence of ownership in a life insurance policy on the grantor's life that names the trust as beneficiary, and not transferring ownership of the insurance policy within 3 years of death (IRC sections 2042 and 2035), as discussed above.

The primary disadvantages of an irrevocable living trust are giving up control of the timber property and other assets placed in the trust, and keeping a permanent hands-off posture. Of course, there also are the costs of distributing the trust corpus upon termination of the trust. Gift taxes also will be due if the transfer to a trust exceeds the \$12,000 (\$24,000 for split gifts; 2008, as indexed) annual gift tax exclusion per beneficiary (donee), plus whatever applicable lifetime gift tax exclusion is available.

**Revocable living trust**—A revocable living trust may be changed or terminated by the grantor at any time and may be funded or unfunded. It provides an opportunity for the grantor to try out different provisions and make changes to meet his (her) goals. Because it is revocable, there are virtually no tax savings with this type of trust. Any trust income is taxable to the grantor, and at his (her) death, the fair market value (or special use value if elected; see chapter 12) of the trust assets is taxable to the estate. There is no gift tax, however.

The advantages of a revocable living trust include:

1. Avoiding probate for the trust assets
2. Avoiding interruption of family income upon either the grantor's death or his (her) becoming incompetent
3. Providing a trial period for trust operation and the power to make subsequent changes based on experience
4. Consolidating scattered real estate such as forested properties in two or more States and avoiding ancillary probate by putting the title in trust
5. Enabling a business or other enterprise, such as a forest land, to continue operating



6. Relieving the grantor of an administrative burden such as timber management
7. Having generally less accounting and administrative requirements than a testamentary trust
8. Being possibly less vulnerable to judicial challenge of the grantor's capacity as compared to a testamentary trust
9. Depending on State law, possibly barring the statutory rights of a surviving spouse to a share of the decedent's property and putting the property beyond the reach of the grantor's creditors
10. Serving as an instrument to accept death benefits from employee plans and life insurance proceeds on the grantor's life

A revocable living trust has many advantages, but it is essential to have the instrument carefully drafted and coordinated with the grantor's will. As noted above, the disadvantages are that trust income is taxable to the grantor and the trust assets are includable in the grantor's estate.

A revocable living trust becomes irrevocable on the grantor's death (unless terminated at that time) and then becomes eligible for the tax advantages associated with an irrevocable trust. A revocable living trust may be established to avoid death taxes upon the death of the beneficiaries, although this procedure is subject to the generation-skipping tax. The trust incurs the cost of establishment and operation during the grantor's life and may incur additional costs at death, such as those associated with filing Federal estate and State death tax returns.

**Standby trust**—The standby trust typically is revocable, but may be designed to become irrevocable on the grantor's disability. It provides supervised control and investment management if the grantor is disabled or absent, but income is taxable to the grantor and the fair market value of the trust property is includable in the estate. There is no gift tax liability.

Essentially, the standby trust is designed for the contingency of the grantor becoming unable to manage his (her) affairs for any reason. Its primary advantage is the prevention of incompetency proceedings under State law, while at the same time protecting the grantor's assets and providing for his (her) financial needs. The disadvantage is that there are no income or estate tax savings. Additionally, the standby trust may not be available under the laws of some States; however, the same general purposes may be achieved with a durable power of attorney (see chapter 5).

**Pourover trust**—The pourover trust is a living trust that may be either revocable or irrevocable, funded or unfunded. Its purpose is to receive and accumulate payouts and proceeds from various sources as they occur over time. The

tax treatment is the same as for other living trusts discussed above, depending on revocability. The pourover trust can be very useful as a means of collecting funds from disparate sources such as annuity checks, individual retirement accounts, Keogh plans, insurance policies, qualified employee benefit plans, and assets from estates and other trusts.

The pourover trust can be established to give the primary beneficiary of a life insurance policy a life interest in the insurance proceeds rather than receiving them outright. The corpus of the proceeds is then directed to others on the death of the primary beneficiary and does not become part of his (her) estate. Pourover trusts are relatively new and some technical issues remain unresolved. When used with a will, the trust should be in existence before the will is executed; it also should be kept separate and incorporated in the will by reference.

**Grantor retained income trust**—With the grantor retained income trust (GRIT), grantor retained annuity trust (GRAT), and grantor retained unitrust (GRUT), the grantor reserves a qualified term interest in the form of either a fixed dollar or fixed percentage annuity (IRC section 2702). At the end of the specified term, the principal passes to the remainder persons. The nontax benefits are negligible, and the trust income is taxable to the grantor. The value of the trust corpus is not includable in the grantor's estate unless he (she) dies within the reserved income term (period). The gift tax due on establishment of the trust depends on the value of the remainder interest at the time the trust is created.

Current rules substantially limit the use of GRITs that provide transfers for the benefit of family members, defined to include the transferor's spouse, ancestors of the transferor or transferor's spouse, lineal descendants of the transferor or transferor's spouse, brothers and sisters of the transferor, and spouses of the above. Family members do not include nieces, nephews, or friends. There are special rules for the valuation of tangible nondepreciable property, especially undeveloped land such as forest land that generates limited or uncertain income. Under IRC section 2702(d) the valuation of the term interest is the amount that the holder of the term interest establishes as the amount for which the interest could be sold to an unrelated third party.

The term of GRATs and GRUTs is not limited by statute but by practical considerations. If the grantor dies within the term, the principal is taxable in his (her) estate. Thus, the period of the trust should be substantially shorter than the grantor's life expectancy.

## Testamentary Trusts

Trusts created in accordance with instructions contained in a decedent's will are known as testamentary trusts. They provide supervised control and investment management of the trust assets, and trust income is taxed to the beneficiaries if currently distributed. The fair market value of the decedent's assets that are put into the trust is includible in his (her) estate, but there is no gift tax liability. Generally, a testamentary trust is used by individuals who are unwilling to give up control of assets while alive.

The advantage of a testamentary trust is that it can protect the trust property from successive estate tax levies as the income is used by successive generations, such as the surviving spouse, the children, and grandchildren. The generation-skipping transfer tax may become applicable upon final disposition of the property. The non-marital credit trust is a good example of an estate tax-saving testamentary trust. Up to \$2 million (2006 through 2008) of the decedent's assets, including forest land, could be put into trust at the decedent's death and qualify for the allowable credit. The trust then would pay the surviving spouse income for life and permit use of the principal subject to ascertainable needs, but withhold control from him (her). The property thus would not be taxed in either the decedent's or the surviving spouse's estate and the corpus would pass to the children or other second generation beneficiaries' estate tax-free.

**Example 9.2.** When he died in 2008, Green owned 2,500 acres of forest land. Three-fifths (1,500 acres) was stocked with young pine plantations valued at \$2 million, in which the timber was growing at rates varying from 15 to 25 percent per year. The other two-fifths (1,000 acres) was stocked with mature sawtimber valued at \$3.5 million. Assume that this constituted the net taxable estate for his spouse, two married children, and four grandchildren. None of the applicable credit amount had been previously utilized.

Green's will contained a marital deduction formula clause which directed \$2 million into an applicable credit trust (see fig. 9.1). This entire transfer was protected from estate tax by the \$780,800 applicable credit amount. The trustee had the discretion to pay the surviving spouse the trust income if needed, plus the option to invade the principal for her benefit, subject to an ascertainable standard of living. The executor funded this bequest primarily with the young plantations so that the rapid appreciation would accumulate tax free for the children and their families. As a practical matter some mature timber was included to provide liquidity in this trust until thinning income from the plantations was sufficient to meet cash flow needs. The balance

of the estate, \$3.5 million primarily in mature timber, went into a marital deduction trust for the surviving spouse.

As a result, Green's bequest to the children was shielded from estate tax by the applicable credit amount; his bequest to the surviving spouse was shielded from estate tax by the marital deduction; and the opportunity remains to use the applicable credit amount an additional time to shield part or all of the surviving spouse's estate—up to \$2 million if she also dies in 2008 and up to \$3.5 million if she dies in 2009—from tax. This strategy results in considerable savings of estate tax and administrative expenses (see table 2.1).

If the surviving spouse has sufficient assets of her own that taxes on her estate remain a concern, she can thin the estate by a combination of pursuing personal interests—such as a yen for travel—and aggressively taking advantage of the exclusions for gifts under the annual exclusion and gifts of tuition and medical expenses. The major disadvantage of placing forest land in trust is that all reforestation expenses must be amortized over 84 months because, unlike other taxpayers, trusts are not eligible to immediately deduct the first \$10,000 of such expenses.

## The Importance of Flexibility

Trusts usually are drafted to last for many years; it is difficult, however, to anticipate all the changes that can affect family finances over a long period. With a revocable trust, provisions can be revised or added by the grantor as required. With an irrevocable trust, however, the provisions need to be built with enough flexibility that the trustee can continue to achieve the grantor's objectives even if conditions change. Though many grantors find it psychologically difficult to adopt them, there are a number of provisions that can be added to an irrevocable trust to add flexibility and safety for both the family and the trust assets.

**Income-sprinkling clause**—This provision permits the trustee to act as a surrogate family member by distributing or accumulating income according to guidelines established by the grantor. When there are multiple beneficiaries, the guidelines should provide preferences and priorities with respect to the needs and purposes to be accomplished for each. The guidelines also should address the treatment of excess income and plans for distribution as minor beneficiaries come of age. This can be done by a letter outside the trust instrument, or in the case of forested land, it can be included in the forest management plan. Income-sprinkling clauses most often are used to address the unforeseen needs of minor children. Where there is more

than one child the grantor may wish to consider a separate trust for each, to avoid conflicts. Income-sprinkling clauses also can be used to provide for surviving spouses with fixed minimum levels of income, by giving the trustee the power to distribute additional funds to the spouse as needed.

It is important that the grantor be distanced from the decisions in order to avoid having the assets revert to his (her) estate. The choice of the trustee is critical, and an institutional trustee may need to be paired with a co-trustee who knows the needs of the family members.

**Invasion of trust principal**—The trustee should have the discretion to use the trust principal to benefit the income beneficiaries under an “ascertainable standard.” Under Internal Revenue Service (IRS) regulations, this may include education (including college), support in reasonable comfort, health care, and other factors.

**Power of beneficiary to withdraw principal**—The beneficiary may be given the power to withdraw principal subject to the limitation that the total amount withdrawn in any 1 year may not exceed \$5,000 or 5 percent of the value of the current trust property, whichever is greater. In this way, the beneficiary is not totally subject to the trustee’s discretion, and only the annual right of withdrawal is included in the beneficiary’s estate.

**“Crummey” power**—Here the beneficiary is given a limited unilateral power, called the “Crummey” power, to withdraw income or principal or both from the trust. The power is exercisable only for a limited period of time, such as 30 days, each year. Inclusion of the “Crummey” power in a trust permits gifts made to the trust to qualify as gifts of a present interest, so they qualify for the annual gift tax exclusion (see chapter 8).

**Other provisions**—Beneficiaries with disabilities can be provided for by defining “disability” and setting trust distributions for the benefit of such persons. Spendthrift provisions can expressly reject assignment of trust income to creditors or others in anticipation of income distributions by the trustee. Efficiency provisions can provide for termination of the trust by the trustee if trust administration becomes uneconomical. Although anticipating changes in the economy is nearly impossible, a sprinkling provision in the trust can allow beneficiaries’ needs to be addressed in terms of inflation over time. Unitrust (see chapter 8) provisions might be considered that provide the beneficiaries the greater of the trust income or a fixed percent of the trust principal. The trustee may be given hold-back powers to delay or cancel trust distributions upon unacceptable behavior by a beneficiary—for example, if the beneficiary is involved with drugs or in a divorce proceeding. The grantor may wish to designate the age at which a beneficiary will

receive distribution of trust principal so that he (she) will have time to mature.

## Use of Trusts and Disclaimers in Marital Deduction Planning

Generally, the goal for married couples with significant wealth is to eliminate all estate taxes at the death of the first spouse and to minimize estate taxes on the death of the surviving spouse. This usually is done with a marital deduction bequest, which may be either outright or in trust (see chapter 6). Planning for a marital deduction trust must be coordinated with the bequests to the children or other heirs covered by the applicable credit amount, if the applicable credit is to be utilized. The applicable credit portion also can be outright or in trust. Thus, if professional management of the forest land will be in the surviving spouse’s best interest, trusts can be used for the marital deduction bequest, the applicable credit bequest, or both. A trust also provides protection against demands by children and creditors. For the remainder of this discussion, it is assumed that both bequests will be in trust.

The applicable credit trust (sometimes called a non-marital credit trust) provides for the surviving spouse as beneficiary, if he (she) needs the income, and the trust principal will be exempt from Federal estate taxation on his (her) death (see fig. 9.1 and example 9.2). It can include income-sprinkling provisions as discussed above. The trust can provide that the income provision terminates upon remarriage of the surviving spouse; perhaps more importantly, it can be designed to realize the maximum benefit of estate appreciation when the grantor desires for some reason that the surviving spouse not benefit from appreciation.

In addition, several types of marital deduction trusts may be utilized. These include qualified terminal interest property (QTIP) trusts, power of appointment trusts, and estate trusts. The choice among these should be made based on accomplishing the grantor’s goals most effectively.

### QTIP Trust

The QTIP trust provides the surviving spouse with a life interest in the trust principal, without having the principal enter his (her) own estate. At the same time, it allows the grantor full use of the marital deduction for trust assets in his (her) estate while retaining control over disposition of the remainder interest in the trust after the surviving spouse’s death. A QTIP trust is a particularly useful tool with blended families. The decision of whether to use it is more personal than tax-related, but a QTIP trust can protect the interests of the grantor’s children in second or third marriages. The surviving spouse must be given the trust income payable, at least annually, for life. The QTIP election must be made by

## Two Estate Transfers—MD and Credit

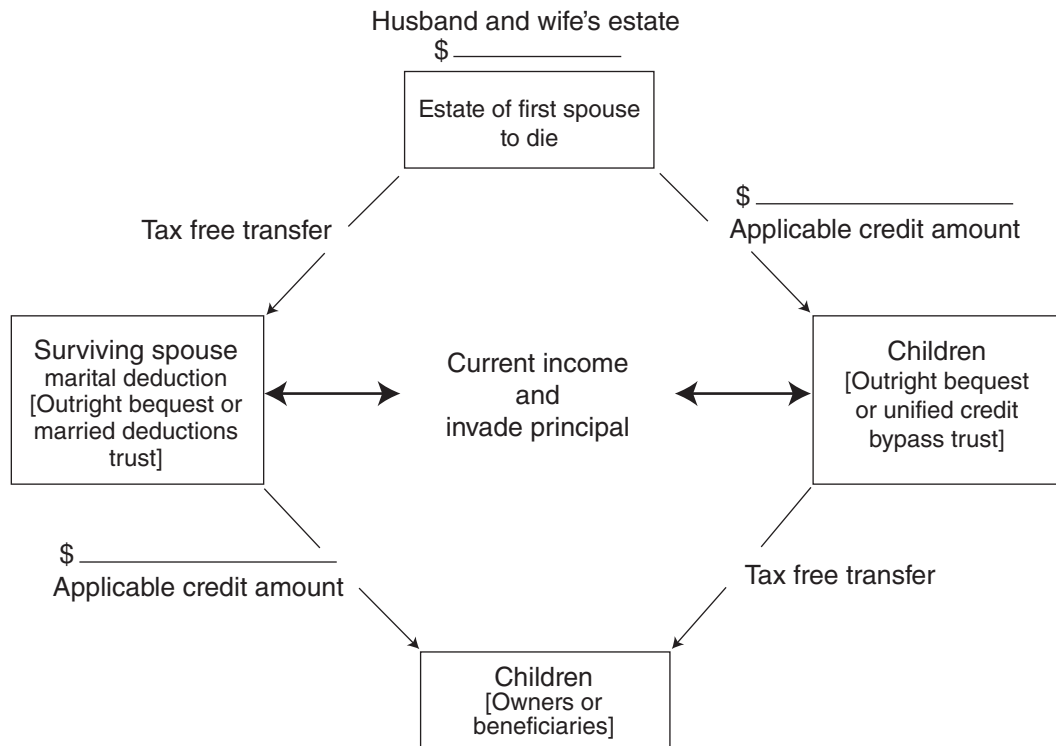


Figure 9.1—Marital deduction and applicable credit planning for two estate transfers.

the executor, and a full or partial election can be made based on the form of the bequest and the degree of utilization of the full applicable credit amount. For a more extensive discussion of QTIPs, see chapter 6.

### Power of Appointment Trust

The power of appointment trust gives the surviving spouse a life income interest in the trust property, which must be paid at least annually. The surviving spouse or trustee is given the right to use trust principal for designated purposes such as making gifts that qualify for the gift tax annual exclusion. Although it is not necessary that this right be exercised, it is a means of reducing estate taxes in the surviving spouse's estate. A general power of appointment exercisable by will also gives the surviving spouse the right to provide in his (her) will for the disposition of the trust assets at his (her) death. The trust provides that, if the surviving spouse fails to exercise the right to name the beneficiaries of the trust assets, the assets will pass to beneficiaries, if any, named in the trust by the grantor.

### Estate Trust

The estate trust is designed for the surviving spouse who does not need income. The trustee may be given the discretion to make distributions based on need, but the surviving spouse does not have a right to demand them. The trust assets qualify for the marital deduction as long as the trust ends on the death of the surviving spouse and the trust assets are to be paid to the surviving spouse's estate at that time. Thus, the survivor's will controls the disposition of the trust assets. This type of trust also can eliminate income distributions on remarriage of the surviving spouse and accumulate them for the eventual benefit of the surviving spouse's heirs. As well, it can hold non-income producing property with growth potential, such as forest land, which might pose a problem with a power of appointment trust.

**Non-marital trust**—The non-marital trust is used as a “backup.” It can be highly effective as a measure to meet current or future income needs of the intended beneficiaries, while avoiding inclusion of the trust assets in the estate of the surviving spouse at his (her) death.



**Portion trust**—A portion trust is one administered as a single trust but which contains two or more sub-trusts, each with its own allocation provisions. A portion trust may work where the cost of a two-trust plan, using the marital deduction and applicable credit bypass trusts, is too high, or where asset values are too low to attract a professional trustee to accept one or both trusts.

### Disclaimer

A disclaimer by a surviving spouse is valid even if the will directs the property disclaimed to a marital deduction trust in which the surviving spouse has an income interest. Similarly, the children can use a disclaimer to disclaim bequests that will permit the surviving spouse to receive a larger marital deduction amount (see chapter 7).

### Trustees

The selection of and powers given to trustee(s) is a critical issue that can bedevil an otherwise sound trust plan. The person or institution chosen as trustee must, of course, measure up in a practical sense. If forest land is an important part of the estate assets, a forester with business experience may be preferred, if not as sole trustee, perhaps as a co-trustee. Ability, integrity, judgment, and durability all are important qualities for a trustee. State law requirements must be satisfied; this is important particularly with respect to the rules regarding trust property in one State and trustee(s) who reside in another State.

Tax considerations come into play if the grantor names himself (herself) as trustee with powers over income and principal, which can make the income taxable to the grantor. Similarly, if nongrantor trustees have the power solely or partially to vest income or principal in themselves, the trust income would be taxable to them.

### Individual versus Institutional Trustee

A family member who has all the requisite skills and experience may be persuaded to be named a trustee and perhaps serve without a fee. That may not be fair to the trustee, however, because it takes valuable time to do the job right, and the family member may come to resent the duties involved and/or make them a low priority if uncompensated. On the other hand, an institutional trustee (usually in a department with several individual specialists), though it offers experience, continuity, and a variety of skills, may not have the personal interest in the forest assets or in the beneficiaries that a family member would have.

Trustee fees should be investigated and negotiated while the grantor is alive. For institutional trustees, there are

acceptance and termination fees, as well as minimum annual management fees for handling trust investment and income distributions. There may be additional fees for handling timber sales, preparing fiduciary income tax returns, and other services. These fees will vary by institution and should be carefully investigated when determining if an institutional trustee has the ability and the interest in the forest land to do the job that the grantor requires. There always is the element of uncertainty over an institutional trustee's acceptance of the trust corpus. Is the property sufficiently large to be attractive, and will the trustee have the skill to manage it effectively? Some trust departments are experienced at managing forested properties, but others may want to dispose of the forest land and invest in more liquid investments.

### Family Co-Trustees

In some cases a family member may serve as co-trustee with an institutional trustee, bringing knowledge of the personal needs of the beneficiaries, and sometimes, a personal attachment to the forest property. This arrangement will cost more, even if the co-trustee serves without fee, because additional time will be required for meetings, consultations, and resolution of conflicts. The co-trustee also may require a fee, which would be an additional expense. Benefits and costs should be carefully considered and balanced; appropriate language should be included in the trust instrument to ensure that favorable tax treatment will not be compromised if beneficiaries serve as co-trustees.

### Successor Trustees

Naming alternate trustees should be considered, since the capacity of the original trustee(s) to serve may change at some point in the future. Family members age, move, or die; institutions also change or go out of business. Alternate trustees should be named or procedures put in place to address such contingencies. Foresight in this area may save court fees, bond costs, and valuable time. A grantor can retain the power to appoint a successor institutional trustee only if the trustee resigns or is removed by judicial order (Revenue Ruling 77-182, 1977-1 CB 273); broader powers to the grantor will most likely result in the property being includable in his (her) estate.

### Trustee Powers

The trustee should be given sufficient power to accomplish the grantor's objectives. Default provisions of State law will address any powers omitted from the trust instrument. With timber assets, special provisions may be needed to address the distinction between principal (the volume of merchantable timber present at the time the trust is created) and income (the subsequent growth). Because forest land

may not produce income in some years, the allocation of value appreciation should be considered. In years with income, the allocation of timber sale revenue to capital expenditures, operating expenses, and income distributions must be addressed. It may be prudent to include other income-producing assets in the trust to cover expenses in years there is no timber income or to permit retention of some timber sale income for forest management purposes. The trustee needs sufficient flexibility to respond to changing economic and environmental conditions, market opportunities, and beneficiary needs.

## Chapter 10

### Life Insurance

#### Role of Life Insurance

##### Insurance Program

A life insurance program should be an integral part of the overall estate plan. The estate planner should review all of the forest owner's policies, inventory the provisions and benefits, and make estimates of needed insurance changes over time in conjunction with other estate assets.

There are two primary reasons for buying life insurance: (1) to replace income foregone at the death of the principal breadwinner, and (2) to provide liquidity. The first reason obviously is to meet the needs of the surviving family for living expenses. The second is to prevent shrinkage from forced liquidation of estate assets under unfavorable terms, to cover the cost of estate administration, and to pay any estate taxes.

For a young family with limited assets and heavy financial commitments, insurance protection is a necessary expenditure. Many observers have noted that the family's greatest insurance needs peak immediately following the birth of the last child (see fig. 10.1). Insurance can provide an instant estate for the surviving spouse in the event the primary breadwinner dies prematurely. Over time, the family's insurance needs generally decline with the move to self-sufficiency of the children and the accumulation of capital assets such as homes, timberland, and retirement benefits.

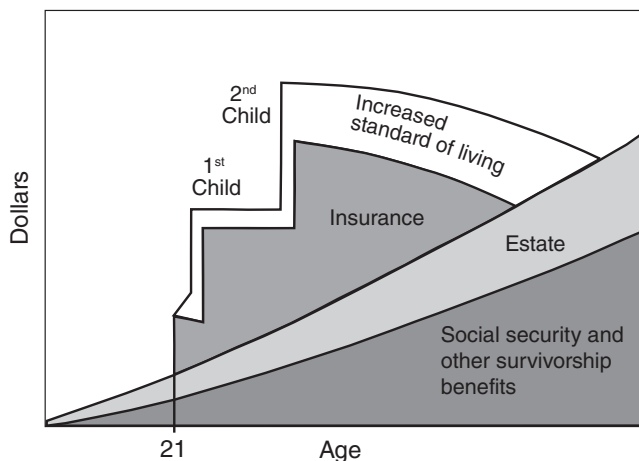


Figure 10.1—How much insurance is enough? Source: Harl, Neil E. 1988. *Farm, estate and business planning*, 10<sup>th</sup> Ed., Niles, IL: Century Publications, Inc., 411 p.

There are alternatives to insurance for liquidity purposes such as government and corporate bonds, and publicly traded securities. These investments fluctuate in value, and there always is the risk that one or all could be at a low point in their cycle when cash is needed. Many life insurance policies carry an investment component with highly-rated companies, which is relatively safe. Insurance firms are highly regulated and well diversified; a minimum return usually is guaranteed with policies that have an investment component. A policyholder should be cautious, however, in relying on projected returns since they are projections and usually not guaranteed.

Insurance payable to a named beneficiary is exempt from death taxes in most States. Life insurance also receives favorable tax treatment under the Federal estate tax laws. Insurance proceeds payable to beneficiaries other than the insured's estate are exempt from tax if the decedent retained no incidents of ownership in the policy for the 3 years prior to death and no beneficiary is required to use any of the proceeds for the benefit of the estate; life insurance proceeds, therefore, may be paid to an executor if the executor can keep the proceeds for his (her) own benefit. Insurance also is treated favorably for income tax purposes at the Federal level and in most States. In addition to favorable tax treatment, insurance benefits can include the flexibility of different settlement options, financial security for survivors, and the convenience of low-interest cash value loans should the policyholder need them.

**Life insurance contract**—Perhaps, the most important provision of the insurance policy is that of ownership. The policy owner exercises control over the insurance contract. The owner can name one or more beneficiaries, including contingent beneficiaries; in addition, the owner can control the payment options depending on the needs of the beneficiaries (although the procedural rules of the policy should be followed carefully). In most cases, the insured is the policy owner which results in the proceeds of the policy entering his (her) estate at death. If, however, the owner divests himself (herself) of all incidents of ownership for at least the last 3 years of life (see below for more discussion of this rule) and names a beneficiary other than his (her) estate, the proceeds will not be included in the estate.

The insurance contract lists the cash value schedule, if any, over time. The cash value is a close approximation

of the policy's gift tax value. If a policy is a participating type, it will stipulate how the dividends—the nontaxable return of excess premiums—will be paid. It describes the various options that are available for dividends such as cash payments, paid-up additions, retention of premiums with interest, and others.

In the event that premiums are not paid in a timely manner, most permanent insurance provides for a period of extended coverage as term insurance. This generally is not the preferred method for adjusting coverage. If the owner decides to stop paying the premiums on the policy, paid-up insurance can be obtained instead of cash.

The insurance policy will spell out the procedural rules for making an assignment of the policy. This normally must be done in writing and must be received by the company to be effective. Many newer policies have special provisions for so-called "living benefits" that are available if the insured contracts a terminal illness. In effect, the insured draws on the death benefits during his (her) life to cover living expenses associated with the illness.

Permanent insurance (as compared to term) permits the policy owner to borrow a specified proportion of the policy's cash value. The contract has a guaranteed interest rate that usually is lower than the rate charged by commercial lenders. There also are various options for loan repayment, as well as provisions for premium payment with loan proceeds.

**Definition of life insurance**—Life insurance is defined for the purposes of income, gift, and estate taxes in section 7702 of the Internal Revenue Code (IRC). The applicable test basically is a distinction between contracts for life insurance and thinly veiled investment vehicles. If an insurance policy fails to meet the test, the pure insurance component—the difference between the cash surrender value and the death benefit—is treated as term insurance and qualifies for the income tax exclusion, while the cash surrender component is treated separately with the income being taxable to the insured. In this context, income is defined as the amount by which the net surrender value, less the cost of insurance, exceeds the premiums paid, less any dividends credited. This means that all accumulated earnings—not just those for the current year—are included in the policyholder's gross income each year and taxed as ordinary income.

Thus, buying an investment contract disguised as an insurance policy carries the added risk of disqualification by the Internal Revenue Service (IRS). If life insurance is needed, a forest landowner should buy an appropriate policy. The types of insurance are described below.

## Estate's Needs

The estate's needs should be considered, the alternatives for meeting family needs should be evaluated, and the cost of meeting these needs with insurance assessed.

## Uses

Insurance may provide equity for absentee heir(s) who have chosen to live and work away from the forest land. Insurance can provide liquidity to pay estate or other debts, protect a dependent's income stream, and perhaps accumulate funds for the forest landowner's retirement. For young couples, insurance can create an instant estate for the surviving spouse and children in the case of untimely death.

## Types of Insurance

Insurance comes in many combinations of protection and investment. Term insurance (pure protection) is the least expensive and provides the greatest protection per dollar invested in the short run; however, it may not be the best vehicle over time because the rates increase with the age of the insured and a person may eventually become uninsurable. Term insurance is a means of deferring risk until the owner can afford a higher-cost policy with an investment component. The ultimate choice of pure insurance versus insurance with an investment component depends on the opportunity for sound outside investments, the tax effect (including both the rates and whether the investment component gets tax-free buildup), the premium cost and amount of cash buildup—and finally, the probability of the insured dying with the policy in force. A policy that provides cash buildup generally will provide a lower death benefit than a policy purchased at the same price with no cash buildup. A cash buildup policy, however, increases the pool of funds against which the insured can borrow at a favored rate for any purpose.

## Term Insurance

The primary characteristic of term insurance is low-cost protection, making it most suitable for insureds such as young married couples with children, who need a large amount of coverage for a relatively short period of time. Policy premiums are related directly to the probability of death. Some policies may be converted to whole life (see below) without a physical examination, which guards against the problem of uninsurability. Term insurance is sold either in fixed benefit policies with increasing premiums or in decreasing term policies with fixed payments. It can be a good idea to use a decreasing term policy in conjunction with mortgage redemption, installment contracts, or short-term loan repayments.

## Whole Life Insurance

Whole life (sometimes called ordinary life) insurance combines the pure protection feature of term insurance with an accumulating cash value. Whole life is the most common type of insurance; the cash value feature provides a ready source of emergency funds for insureds such as young single people and newly-married couples. The premiums and death benefit generally are fixed with a whole life policy, as are the maturity date and the buildup of cash value. The rate at which cash value accumulates under a policy should be compared with alternative saving and investment opportunities.

## Other Insurance

Numerous insurance options are available to meet specialized needs, but all should be compared with alternatives. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA; Public Law 100-647) not only changed the definition of insurance, but also instituted income tax changes for policies that fail a seven-payment premium test. TAMRA created a modified endowment contract (MEC). An MEC satisfies the life insurance test but fails the premium test. That is, the cumulative amount paid for the policy exceeds the sum of the premiums that would have been paid if the policy contract had provided for paid-up future benefits after the payment of seven level premiums. Loans and partial withdrawals are taxed on a last-in, first-out accounting basis. Earnings are treated first and are taxable. In addition the insured has a 10-percent early withdrawal penalty for withdrawals made before age 59½; this penalty also applies to insurance policy terminations.

Single-premium policies were hit hard by TAMRA because they were designed primarily for the investment component. They are attractive to investors for the tax-free buildup and estate tax-free transfer of assets; they also avoid probate and challenges to the decedent's will.

Universal life, limited payment life, and single premium life policies with high investment components have been restricted by changes in the definition of life insurance under IRC section 7702. Universal life and variable life policies separate the cash value and term protection elements of whole life. The investment option will cover the term insurance portion of the premium. If the investment side of the policy fails to earn enough for the insurance portion, then additional premiums are required or the death benefit is reduced. These policies are most attractive to high-income individuals who want the tax-free buildup.

Spousal or second-to-die insurance is used primarily to pay the estate tax liability of the surviving spouse. It often is used in conjunction with a charitable remainder trust

(see chapter 8) to replace the principal that went into the charitable trust. First-to-die insurance often is used in buy-sell agreements to balance the interest of the heirs who choose to live in other areas with those who choose to live on the forest land and continue to help with the day-to-day management.

## Estate and Gift Tax Considerations

### Proceeds

As noted above, life insurance proceeds are included in the gross estate if the decedent retained "incidents of ownership" in the policy or if the proceeds are payable to the estate. Transfer of policy ownership within 3 years of the decedent's death also will result in the proceeds being included in the decedent's estate, together with any gift tax paid, as discussed in chapter 8.

**Example 10.1.** After careful planning, the taxable estate of a forest landowner was exactly \$2 million. Unfortunately, the owner forgot about a life insurance policy for \$200,000 that he owned and which was payable to his estate. At his death, the policy was includable in his estate, and the \$200,000 that he had intended for the heirs' benefit was reduced to \$110,000 since it was subject to Federal estate tax at 45 percent. Also, depending on the State of residence, State death taxes may be due.

To avoid the problem illustrated above, all "incidents of ownership" should be divested 3 years or more prior to an insured's death. Incidents of ownership include the power to: (1) change the beneficiaries of the policy, (2) cancel the policy, (3) assign the policy, (4) pledge the policy for a loan, or (5) borrow against the policy's cash value. Reversionary interests, by which the insured may regain one or more of these rights in the event a beneficiary predeceases the insured, or if certain other contingencies occur, should not be held. Additionally, the insured should not pay the premiums on the policy after giving up ownership. Gifts of cash or income-producing property to the policyholder on the insured's life should not be in amounts or timed so as to have the appearance that the insured is supplying funds for the premiums.

### Transfer of Ownership

A transfer of insurance policy ownership results in a gift. The value of a gift of insurance is the cost of replacing the policy—the cash surrender value. The insurance company will provide this value on request; it generally is much smaller than the face amount of the policy.



Premiums paid by the insured for a policy owned by the beneficiaries constitute a taxable gift even though the donee's rights are conditional on their surviving the insured. The \$12,000 annual gift tax exclusion (2008, as indexed) is available for the transfer of the insurance policy and for making gifts of the premium payments; the allowable \$1 million lifetime gift tax credit also can be used. If a gift is made to cover premium payments for insurance held by a trust, the gift is treated as a future interest and the annual exclusion is not available unless the Crummey power (see chapter 9) is included. If the donor makes a split gift of insurance or premiums within 3 years of death, the value of the gift reverts to the donor's estate [IRC section 2035(c)(3)].

If the policyholder dies before the insured, the value of the unexpired policy is included in the policyholder's estate. The value is the interpolated term reserve; the insurance company will provide this value.

To avoid problems of inclusion, a younger family member should be made the owner or the insurance should be put in trust. The trustee of a revocable trust should not be designated as a beneficiary nor should a policy be subject to a loan; both situations cause problems.

## Choice of Primary and Contingent Beneficiaries

### Tax Liability

Beneficiary designation is important in determining whether policy proceeds are subject to Federal estate tax. The policy owner has nearly complete freedom in naming a beneficiary. Should it be the spouse, the estate, the executor of the insured, the trustee of either a lifetime trust or a testamentary trust established by the insured, or one or more individuals?

If the proceeds are made payable to the estate, they are includable in probate. They also may increase administration costs, and be subject to estate tax. This action will not hurt tax-wise if the estate tax is deferred by virtue of the marital deduction.

But there is a better way.

### Beneficiary Designation

Insurance beneficiary designation is an extremely important part of the overall estate plan—particularly with regard to distribution of assets—and should be coordinated with all other parts of the plan.

Naming as beneficiary a responsible family member who can be trusted to make the proceeds available to meet the estate's liquidity needs is an important consideration. Normally, the spouse is named the beneficiary, with the children listed as contingent beneficiaries. Doing so will avoid probate and, generally, State death taxes. If minor children receive policy proceeds, however, a guardian will have to be appointed for each child, with added expense and complications.

If the owner does not have an individual in whom he (she) has confidence, a trust should be considered.

### Insurance Trusts

An insurance trust can combine the flexibility of trusts with the protection advantages of insurance. It may be funded or unfunded, revocable or irrevocable, and testamentary trusts are possible. The key advantage of naming a trust as beneficiary is greater flexibility in distributing the proceeds to meet the needs of the family. There also is the ability to put restrictions and limitations on the use of funds for beneficiaries under other settlement options. The need for guardians for minor beneficiaries can be eliminated in most cases, subject to State law. The trust can eliminate the second estate tax for life insurance beneficiaries. Depending on the goals of the grantor, the trustee can be authorized to accumulate income and have broad investment discretion for the benefit of the family. The flexibility and use of restrictions are perhaps the most important attributes and must be balanced against the costs—broadly defined—of using a trust.

**An irrevocable insurance trust**—The advantages are avoidance of estate taxes, avoidance of probate, and possibly, avoidance of State death taxes. The reasons noted above for choosing a trust also apply. An irrevocable trust has two big problems for the grantor that were discussed in chapter 9—loss of control and the gift tax liability in establishing the trust. These are complex problems and should be considered in consultation with an estate planner who is familiar with both trusts and insurance.

## Other Considerations

### Settlement Options

Life insurance proceeds may be received under four basic options: (1) interest—paid for a limited time and then another option is selected, (2) fixed period—equal installments paid for a fixed period at a guaranteed rate, (3) fixed income—fixed payments for a specific period after which the balance is payable under some other option, or (4) life income—an annuity for life. The choice basically is

a gamble, and once made, involves rigidity not present in a trust. An insurance specialist should be consulted to arrive at the choice best for meeting the individual's objectives.

### Replacing Policies in Force

Replacing policies in force rarely is advisable due to new acquisition costs, policy value increases with age, a contestable period, unequal dividends, unequal cash value, and replacement by policies of a different type. Especially if the amounts involved are substantial, an insurance consultant—whose fee is dependent on the service provided, not the sale of a particular insurance product—should be consulted.

### How Much Insurance is Enough?

The choice of how much insurance to purchase is highly subjective, but there are some guidelines that can be followed in reaching a logical, affordable, and common sense decision. Rules of thumb such as the 10-times-earning rule should be avoided.

### Income Producer

Insurance should be concentrated on the person who generates the family income, since it is this income stream that needs to be replaced if the person dies prematurely. First, information about the family assets and liabilities and the family estate plan should be assembled—that is, an inventory of family resources. What are the family goals and aspirations? Then, the net value of the assets and liabilities should be projected for a reasonable planning horizon. A 5-year horizon should be sufficient, but not more than 10 years, since anything over 10 years is pure guesswork. The effects of the untimely death of the primary breadwinner should be calculated considering factors such as family income needs due to the loss of his (her) salary and leadership, estate taxes, administrative costs, and funeral expenses.

The status of liquid funds needed to maintain the family's expected standard of living should be evaluated. For example, will the family have to cash saving accounts or harvest timber to meet deficits? What are the family's goals for shelter, college, retirement, and recreation? With regard to the continuity of business, do family goals involve acquiring more forest land or better management of what already is owned?

The process of determining the needs of the immediate family is illustrated conceptually in figure 10.1. How much insurance is needed to protect the family if the primary breadwinner should die before family goals are met? The answer depends on where the family is on the time line. If the available resources are insufficient to meet the goals, there are three basic courses of action: (1) increase earnings, (2) reduce costs, or (3) redefine goals. Insurance can fill some of the gaps.

### Periodic Review

Life insurance policies should be reviewed periodically to evaluate whether they are providing adequate coverage at affordable cost. The concerns outlined above also should be revisited periodically: What are the resources? What are the goals? Can the resources (forest land, timber growing stock, and capital) be increased to produce the income (growth) that is needed to meet family goals? Insurance is one alternative to bring income protection up to the minimum level desired to assure a particular standard of living.





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## Chapter 11

### Installment Contracts

#### General Provisions

If certain conditions are met, the gain recognized on an installment sale of real property can be spread over the duration of the contract for income tax purposes (Internal Revenue Code (IRC) section 453). An outright sale, on the other hand, triggers immediate recognition of all gain in the year of sale. Although using the installment sale method determines when gain from the sale is reported, it does not affect characterization of the gain as a capital gain or ordinary income. The correct category depends on the nature of the asset sold.

Dealers in real and personal property are prohibited from using the installment sale method of reporting. There is, however, a specific exemption to this rule for sales of property used or produced in the trade or business of farming as defined in sections 2032A(e)(4) and (5) of the IRC (see chapter 12). This definition of farming includes timber growing. The use of the installment sales method thus is permitted for taxpayers whose timber ownership qualifies as a farm business under IRC section 2032A; however, a lump-sum (timber deed) sales contract must be used in this case. If a pay-as-cut contract wherein the seller retains an economic interest is used, the proceeds cannot be reported under the installment sales method. Lump-sum sales by timber investors also qualify for installment sales treatment.

In addition to the income tax advantages, installment sales can be a good estate planning tool, as discussed below. Their use has become much more prevalent in recent years for facilitating the lifetime transfer of farm and forest property to succeeding generations while deferring recognition of gain to future years.

#### Basic Requirements

The installment method of reporting gain can be used when at least one payment will be received after the close of the taxable year in which the sale occurs. No payment is required in the year of sale, although one or more can be made. The installment method is available only for reporting gains; losses cannot be deferred but must be recognized in the taxable year of the sale.

**Payments in the year of sale**—Payments in the year of sale include down payments made in a prior year as well as

payments received in the year that the benefits and burdens of ownership pass to the buyer. This usually is the year of transfer of possession, or the year of title passage, whichever occurs first.

**Example 11.1.** A forest landowner agrees to sell his tree farm for \$150,000 and receives a down payment of \$2,000 on September 15, 2008. The first installment payment of \$25,000 is received on April 1, 2009, and possession is given to the buyer at that time. A total payment of \$27,000 (\$2,000 + \$25,000) is reportable by the seller in 2009.

#### Restrictions

Certain restrictions on the use of installment sales should be noted. For example, a sale of depreciable property between related persons, as defined in IRC section 1239(b), cannot be reported by the installment method unless it is established that the transaction did not have as one of its principal purposes the avoidance of taxation.

Another restriction [IRC section 453(g)] governs the sale of nondepreciable property between related parties followed by a resale by the purchaser. If the purchaser sells the property before the installment payments are made in full, the amount realized from the second sale is treated as being received at that time by the initial seller. In other words, the first seller's gain is accelerated to the extent of the payment received by the second seller. In most cases, however, because of the specific provisions governing the resale rule, the related party restrictions will not apply if the second sale takes place more than 2 years after the first. A related person includes a spouse, child, grandchild, parent, grandparent, brother or sister, as well as corporations, partnerships and estates that are 50 percent or more owned, either directly or indirectly, by such persons.

#### Mechanics of the Election

If the eligibility requirements discussed above are met, the installment method of reporting income is automatic for sales of real property and casual sales of personal property unless the taxpayer elects out in writing of such a reporting method. This "negative election" recognizes that almost all taxpayers prefer the installment method of reporting when possible. The negative election must be made on or before the due date, including extensions, for filing the taxpayer's return for the tax year in which the installment sale occurs.

### The Interest Portion of Installment Income

Any stated interest included in a payment is reported separately as ordinary income. If the contract provides for no interest on the deferred payments, or provides for inadequate interest as defined in the Internal Revenue Service (IRS) regulations, the taxpayer is required to impute interest. Imputed interest is reported in the same manner as stated interest. Generally, an installment sale contract provides for adequate stated interest if it calls for interest at a rate no lower than the “test rate;” the test rate applicable to a particular sale can be obtained from the IRS.

The imputed interest rules apply only if some or all of the scheduled payments are due more than 6 months after the date of the sale and at least one payment is due more than 1 year after the date of the sale. The rules do not apply if the sales price does not exceed \$3,000, regardless of the number of payments.

### Computing the Gain

In order to compute the portion of each installment payment to be reported as gain, the selling price, gross profit, and contract price must be determined. The selling price includes the amount of the down payment, the face amount (excluding interest) of the installment obligations, and the amount of any liability or indebtedness that the purchaser assumes. Tentative gross profit is the difference between the selling price and the seller’s basis in the property; realized gross profit is tentative gross profit, minus expenses of the sale. The contract price is the selling price, less any amount of liability or indebtedness assumed by the purchaser. If, however, the liability or indebtedness exceeds the seller’s basis, the excess is not subtracted from the selling price to determine the contract price. Once the realized gross profit and contract price have been calculated, the percentage of each payment to be reported as gain is determined by dividing the realized gross profit by the contract price. The following example illustrates the computation procedure:

**Example 11.2.** A forest landowner decides to sell 150 acres on the installment method and enters into an agreement providing for a \$20,000 down payment, annual installments of \$7,300 (\$7,000 principal, plus \$300 interest) each over a period of 10 years, a final balloon payment of \$37,500 (\$25,000 principal, plus \$12,500 interest), and assumption by the purchaser of a \$65,000 mortgage. The taxpayer’s basis in the property is \$50,000 and sale expenses are \$5,000. The calculations are as follows:

Selling price	
Down payment	\$20,000
Total annual installments (10 x \$7,000)	70,000
Balloon payment	25,000
Assumption of mortgage	<u>65,000</u>
Selling price	\$180,000
Realized gross profit	
Selling price	\$180,000
Adjusted basis	<u>-50,000</u>
Tentative gross profit	130,000
Sale expenses	<u>-5,000</u>
Realized gross profit	125,000
Contract price	
Selling price	\$180,000
Mortgage assumed	<u>-65,000</u>
Subtotal	115,000
Mortgage exceeds basis (\$65,000 – \$50,000)	<u>+15,000</u>
Contract price	\$130,000

The percentage gain on each payment is:  $\$125,000 \div \$130,000 = 96.2$  percent.

That portion received each year of the total \$15,500 [(10 x \$300) + \$12,500] in interest is reported in the year received as ordinary income.

## Estate Planning Considerations

### Advantages

An installment sale contract may be an ideal tool for parents to begin lifetime transfers of forest land to their children. Such contracts could be particularly attractive to a surviving spouse wanting to avoid heavy involvement in management of a tree farm. The following can be accomplished with an installment sale: (1) an interest in the property as security can be retained by keeping the title, (2) a steady annual income can be received for the duration of the contract, with the receipts not subject to the social security tax or reducing social security benefits, (3) management responsibility can be transferred to the children, (4) an opportunity can be provided for the children to acquire an interest in the property with a low down payment, (5) the size of the estate can be reduced by consuming or making gifts of the installment payments received, and (6) because the contract value is fixed, further increases in value after the contract is signed will not increase the size of the estate.

## Disadvantages

There also may be certain disadvantages associated with an installment sale from parents to children that should be considered. For example, the parents may outlive the term of the contract and then have to depend on other sources of income, or inflation may elevate the parents' cost of living to a point where they have difficulty living on the fixed-contract payments. Although an installment contract reduces the uncertainty of available annual income, it increases the uncertainty of outliving one's assets.

## Other Considerations

Careful consideration must be given to establishing the price and terms of an installment sale in order to further the objectives of moving future appreciation out of the parent's estate and to facilitate transfer of ownership and management control from one generation to the next. If the price is too high or the terms too inflexible, the purchaser may be unable to meet the payments.

If parents are concerned that the child (children) purchasing the tree farm will have difficulty generating sufficient cash flow to finance the purchase, they may wish to establish a selling price below market value. The danger of this, however, is that transfers for inadequate consideration will be treated as gifts to the extent that the fair market value of the property exceeds the sale price. The transaction then will be subject to gift tax as well as income tax. If audited by the IRS, transfers of property between family members will be scrutinized carefully to determine whether a gift has occurred. Unless a gift is intended, the parties should structure the sale to ensure that it has the characteristics of an arms-length business transaction.

Although many court decisions suggest that the sale need not be at the top of the market in order to avoid characterization as a gift, the parties should proceed with caution. Because the gift tax statute of limitations does not begin to run until a gift tax return is filed, there always is the danger that the IRS will examine the transaction many years later, perhaps during an estate tax audit, and contend that the sale was in fact a gift. For that reason, if the sale is substantially below market, it might be advisable to file a gift tax return at the time of transfer even though one may not be required and no gift tax due.

## Use of Installment Sales to Facilitate Gifts

On the other hand, an installment sale may facilitate the gifting of forest property by making it possible for both parents together to convey the forest land to their children and avoid the gift tax by keeping annual gifts to each child within the \$24,000 (2008, as indexed; see chapter 8) annual

exclusion amount for split gifts. For example, if the parents already have used their gift tax lifetime exclusions and wish to give the tree farm to their children, the value of the gift in excess of \$24,000 per child would be subject to gift tax. If the parents wished to stay within the \$24,000 limit, they would have to convey the property a few acres at a time or give small fractional interests, neither of which are very suitable alternatives. An installment sale, however, can provide a vehicle for immediate transfer of the forest land to the children while making it possible for the parents to stay within the annual exclusion amount for each child.

For example, assume forest land property is conveyed in exchange for \$150,000 principal amount, with interest bearing notes, payable semiannually for a term of years. If the parents wish to make gifts to the acquiring children, they may forgive one or more of the notes as they become due. Caution must be exercised, however, so that the IRS will not contend that a gift of the entire value of the property occurred in the year of sale. There should be no problem if the notes are legally enforceable and subject to assignment or sale to third parties, if the property is subject to foreclosure in the event of default, and if the parents have no legal obligation to make annual gifts to the children (see *Estate of Kelley, J.W.*, 63 TC 321 (1974), and *Hudspeth v. Commissioner*, 31 TCM 1254, TC Memo. 1972-253; affirmed and reversed 509 F2d 1224 (CA-9), 75-1 USTC ¶9224).

## Installment Obligation Dispositions at Death

### Income Tax Basis

Generally, upon the death of a property owner, the property receives a new income tax basis (the so-called "stepped-up basis"), and the potential gain or loss is eliminated. But on the death of a seller within the term of an installment sale transaction, the installment obligation as an asset of the estate does not receive a new basis. Payments received after death are reported in the same manner, for income tax purposes, as the seller would have done if living. There is, however, a deduction for the estate tax—if any—attributable to the obligation. This feature may pose an income tax disadvantage compared with retention of the property until death. The disadvantage is greatest for property that has appreciated substantially in value.

### Transfer to the Obligor

Previously unreported gain from an installment sale will be recognized immediately by (become part of) a deceased seller's estate, if the installment obligation is transferred by bequest or inheritance from the decedent to the obligor

(purchaser) or is cancelled by the seller's executor. For example, suppose a father sold 100 acres of forest land to his only son John in 2000 for \$126,000 using an installment sale with annual payments. After receiving the first six payments, the father died with the contract passing to John by inheritance. All unreported gain in the installment obligation would be taxable to the father's estate.

In order to avoid this result, installment obligations could be bequeathed to family members other than the obligor. This would mean that family members would own each other's installment obligations, not their own, and that payments would have to continue to be made. Another possible method of avoiding acceleration of income to the estate as a result of a disposition of an installment obligation to the obligor might be to provide that the obligation be transmitted to an irrevocable trust in which the obligor is a beneficiary. The obligor would have to continue to make payments that would constitute income to the trust, but the estate could argue that no taxable obligation had occurred because the trust is treated as a separate taxpayer.

## **Installment Sales by the Estate**

A different rule applies if the estate is the seller under an installment obligation. In that case, distribution of the obligation to the heirs or legatees causes immediate taxation of the gain. For some assets with a new income tax basis received at death, the amount of gain may be little or nothing. But if the sale involves forested property that was valued under special use valuation (see chapter 12), the amount of gain could be substantial. The new basis at death in this case is the special use value, not the fair market value.

**PART III**

**APPLICATION OF FORESTRY-  
SPECIFIC ESTATE PLANNING TOOLS**





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## Chapter 12

### Special Use Valuation

Section 2032A of the Internal Revenue Code (IRC) permits certain real property to be valued for Federal estate tax purposes on the basis of its “current use” rather than its “highest and best use.” This commonly is termed “special use valuation.” Real property may qualify for special use valuation if it is located in the United States and is devoted to either (1) use as a farm for farming purposes, or (2) use in a closely held trade or business other than farming. In either case, there must be a trade or business use; investment property is not eligible. Personal property also qualifies for special use valuation if it is used in connection with eligible real property.

The term “farm” is defined to include forest land. The term “farming purposes” includes the planting, cultivating, caring for and cutting down of trees, and preparing them for market. Qualified property to be specially valued includes buildings, structures, and improvements functionally related to the qualified use. Unrelated items of value such as mineral rights are not eligible.

#### Reduction in Value

Special use valuation cannot reduce the fair market value of the gross estate by more than \$750,000, as adjusted for inflation since 1999; for 2008 the limit is \$960,000. If the forest land in question (and other qualified property) was owned by both spouses, the limitation applies separately to each estate. Consequently, a reduction in value of up to \$1,920,000 is available in 2008. This can have a profound effect on application of the unlimited marital deduction to a forest estate.

#### Community Property

The full statutory reduction in value is allowed for a decedent’s community property interest in forest land and other qualified property, even though the decedent made no contribution to the property (Private Letter Ruling 8229009, April 12, 1982). Revenue Ruling 83-96 (1983-2 CB 156) applies the same rule to all community property eligible for special use valuation. This position was codified by the Taxpayer Relief Act of 1997 (TRA; Public Law 105-34).

#### Qualifying Conditions

In the right situations, special use valuation of forest land can save a substantial amount of estate taxes. Careful planning—both pre-death and post-death—will be required, however, in order to qualify and receive the maximum benefits. There are six major pre-death requirements:

1. The decedent must have been a resident or citizen of the United States, and the property must be located in the United States.
2. The property must pass to a qualified heir or heirs.
3. The decedent and/or a family member must: (a) have owned the qualifying property for at least 5 of the last 8 years immediately preceding the decedent’s death; (b) had an equity interest in the operation at the time of death and for at least 5 of the last 8 years before death; and (c) during at least 5 years of such ownership, the qualifying property must have been used for farming or a closely held business purpose—including timber growing—by the decedent and/or a member of his (her) family, and have been devoted to such use on the date of the decedent’s death.
4. The decedent and/or a family member must have materially participated in the operation of the property for at least 5 years during the 8 year period ending on the earliest of: (a) the date of the decedent’s death; (b) the date on which the decedent became disabled, provided disability continued until the date of death; or (c) the date on which the decedent began receiving social security retirement benefits, provided the benefits continued until the date of death.
5. The adjusted value of the real and personal property qualifying for special use valuation must comprise, at fair market value, at least 50 percent of the adjusted value of the decedent’s gross estate (gross estate, less secured debts). As discussed below, however, the special use valuation election may be made for as little as 25 percent of the adjusted value [Treasury Regulation 20.2032A-8(a)(2)].
6. At least 25 percent of the adjusted value of the decedent’s gross estate must be qualified real property. This test must be met from property actually elected for special use valuation.

Requirements 2 through 6 are discussed in more detail in the paragraphs below.

## Qualified Heirs

The term “qualified heir” is defined as an ancestor of the decedent; spouse of the decedent; lineal descendent of the decedent, the decedent’s spouse, or the decedent’s parents; or the spouse of any such lineal descendent. Where there is a further disposition of any interest in the property from a qualified heir to a member of the qualified heir’s family, such member of the family also must meet the definition of “qualified heir” [IRC section 2032A(e)(1)]. In interpreting this provision, the Tax Court has held that the nephew of a decedent’s predeceased spouse was not a qualified heir because the nephew was not a lineal descendent of the decedent’s parents, but rather was a lineal descendent of the decedent’s spouse’s parents (*Estate of Cone, I.M.*, 60 TCM 137, TC Memo. 1990-359). Also, a disposition by a qualified heir to his cousin within the recapture period (see the Postdeath Requirements section, below) resulted in the recapture tax being imposed because the cousin did not meet the definition of a qualified heir’s family member (Revenue Ruling 89-22, 1989-1 CB 276).

**Possible passage to nonqualified heirs**—All interests in the property to be specially valued must pass to a qualified heir or heirs. Any possibility that all or part of the property may pass from the decedent to a nonqualified heir will render the property ineligible [Treasury Regulation 20.2032A-8(a)(2)]. The Internal Revenue Service (IRS) has disallowed a number of special use valuation elections because not all successive interests in otherwise qualifying real property passed to qualified heirs. For example, the power existing in a trustee or executor to use discretion to place property either in trust for qualified heirs or in trust for nonqualified heirs will destroy eligibility (Private Letter Rulings 8244001, January 14, 1981, and 8441006, June 26, 1984). Also, IRS regulations stipulate that if successive interests are created in the property, such as a life estate followed by a remainder interest, qualified heirs must receive all interests. Nevertheless, the IRS has ruled that an estate could elect special use valuation for property in which a qualified heir received a life estate under the decedent’s will, even though the heir also received the power to appoint the remainder interest in the property to a nonqualified heir. The election was allowed because the heir executed a qualified disclaimer (see chapter 7) of the power of appointment, thus causing the remainder interest to vest in another qualified heir (Revenue Ruling 82-140, 1982-2 CB 208).

**Remote possibility of passage to nonqualified heirs**—Two Tax Court decisions have held that Treasury Regulation 20.2032A-8(a)(2) is invalid to the extent that all successive interests are required to go to qualified heirs. In the Davis case (*Estate of Davis, D. IV*, 86 TC 1156, CCH Dec. 43,105), the Court held that de minimis successive

interests that do not go to qualified heirs will not prevent special use valuation for otherwise qualified property. Similarly, the Clinard case (*Estate of Clinard, C.M.*, 86 TC 1180, CCH Dec. 43,106) limited Treasury Regulation 20.2032A-8(a)(2) by holding that special use valuation is permitted where a qualified heir possesses a life estate with a special power of appointment. In other words, the fact that a qualified heir could direct that an unqualified heir receive a remainder interest would not preclude special use valuation for the interest in question. Both cases recognize that where unqualified heirs are in a position to receive an interest, special use valuation will not be precluded if those interests are exceedingly remote. This principle also has been followed by the United States Court of Appeals for the Seventh Circuit in affirming a decision of a United States District Court in Illinois that allowed special use valuation despite a remote possibility that the contingent remainder interest in the property could pass to nonqualified heirs (*Smoot, L. Executor*, 892 F2d 597 (CA-7), 90-1 USTC 60,002, affirming DC Ill., 88-1 USTC ¶13,748).

**Qualifying property passing in trust**—The rules for the special use valuation procedure apply to qualifying property that passes in trust. However, future interests in trust property will not qualify for special use valuation. Trust property will be considered to have passed from the decedent to a qualified heir only to the extent that the qualified heir has a present interest in the property. Real property otherwise qualifying for special use valuation and passing to a trust may be specially valued even if the trustee has the discretionary power to fix the amounts receivable by any individual beneficiary, so long as all potential beneficiaries are qualified heirs [IRC section 2032A(g)]. As well, if the decedent created successive interests in the trust property that is to be specially valued, all of those interests must be received by qualified heirs.

**Qualified terminal interest property (QTIP) trusts**—The QTIP regulations (see chapters 6 and 9 for discussion of QTIP trusts) may have created a trap for the unwary in the use of a QTIP trust to receive property for which it is planned to make a special use valuation election in the surviving spouse’s estate. Under Treasury Regulation 20.2044-1(b), in order for property passing to a QTIP to be eligible for special use valuation, the remaindermen following the surviving spouse’s life interest must be qualified heirs of the surviving spouse, not of the decedent.

## Qualified Use

The 5-of-8 year’s requirement for pre-death qualified use will be met if either the decedent or a family member has utilized the property for the required time in a qualified use. “Member of family” is defined to include the same persons as listed in the definition of “qualified heir.” Further, the IRS

has interpreted the qualified use requirement to mean that the decedent or a family member must have borne some of the financial risk (had an equity interest) associated with the operation (Technical Advice Memorandum 8201016, September 22, 1981). In furtherance of this concept, numerous court decisions have held that a cash lease of otherwise qualified property by the decedent, particularly to nonrelatives, did not constitute a qualified use.

**Profit-making activity**—The IRS also has mandated that qualified use be synonymous with a profit-making activity by the decedent (Private Letter Ruling 8820002, February 8, 1988). Here the estate included woodland and a cattle operation. The woodland was ruled ineligible because no timber had been cut from it, there were no records of regular inspections or maintenance activities, and there was no showing of an intention by the decedent to profit from timber growing and harvesting.

**Christmas tree operations**—In Private Letter Ruling 9117046 (January 29, 1991), the IRS ruled that an executor of an estate was entitled to make a special use valuation election for a Christmas tree farm. The farm was qualified real property because it was used for farming purposes. It was willed to qualified heirs who were children of the deceased, all of whom also had materially participated in the operation of the tree farm for the required length of time by making all management decisions and performing substantially all of the physical work.

### Material Participation

The material participation regulations adopted under IRC section 2032A discuss in detail the factors to be considered in determining whether the decedent and/or a family member materially participated in operation of the property in question for the required period of time prior to the decedent's death. No single factor is determinative; each situation stands on its own set of facts.

**Employment and management**—Physical work and participation in management decisions are the principal factors considered. At a minimum, the decedent and/or family member must have regularly advised or consulted with the other managing parties (if any) on operation of the business. The decedent and/or family member need not have made all management decisions alone but must have participated in making a substantial portion of the decisions. Production activities on the property should be inspected at regular intervals by the participant.

**Financial risk**—Another factor considered in the determination of material participation is the extent to which an individual has assumed financial responsibility for the business. This includes the advancement of funds and

assuming financial responsibility for a substantial portion of the expenses involved.

**Self-employment tax**—Payment of self-employment taxes on income derived from the business also is an indicator of material participation, although payment of such taxes is not conclusive evidence. If, however, the taxes have not been paid, material participation is presumed not to have occurred unless the executor demonstrates otherwise and explains why no tax was paid. With a timber operation, of course, the presumption would be that all timber income is capital gain under section 631 of the IRC—not ordinary income—and, therefore, not subject to the self-employment tax. Thus payment or nonpayment should not be a consideration with respect to specially valued forest land unless timber sale receipts are reported as ordinary income.

**Multi-participation**—The sole activities of either the decedent or a family member must amount to material participation at a given time, because the activities of more than one person at a given time cannot be considered in the aggregate. If nonfamily members participate in the business, part-time activities by the decedent and/or family members must be pursuant to a provable oral or written agreement providing for actual participation by the decedent and/or family member(s).

**Passive activity losses**—The estate of a decedent who reported losses from a ranch as passive activity losses, rather than losses from an active trade or business, could not elect special use valuation because the decedent had not materially participated in the ranch operation during her lifetime (Technical Advice Memorandum 9428002, March 29, 1994).

**Active management**—A special rule applies to liberalize the material participation requirement with respect to a surviving spouse who receives qualifying property from a decedent in whose estate the property was eligible for special use valuation, whether or not such valuation actually was elected. Active management by the surviving spouse will satisfy the material participation requirement for purposes of electing special use valuation in the surviving spouse's gross estate. The IRC defines active management as the making of management decisions of a business rather than daily operating decisions.

**Tree farm considerations**—Example 7 of the IRC section 2032A material participation regulations concerns a tree farm. Although not definitive of every forest land situation, the example does provide an insight as to how the IRS views material participation with respect to forest land.

**Example 12.1. Treasury Regulation 20.2032A-4, Example 7.** K, the decedent, owned a tree farm. He

contracted with L, a professional forester, to manage the property for him as K, a doctor, lived and worked in a town 50 miles away. The activities of L are not considered in determining whether K materially participated in the tree farm operation. During the 5 years preceding K's death, there was no need for frequent inspections of the property or consultation concerning it, inasmuch as most of the land had been reforested and the trees were in the beginning stages of their growing cycle. However, once every year, L submitted for K's approval a proposed plan for the management of the property over the next year. K actively participated in making important management decisions, such as where and whether a precommercial thinning should be conducted, whether the timber was adequately protected from fire and diseases, whether fire lines needed to be plowed around the new trees, and whether boundary lines were properly maintained around the property. K inspected the property at least twice every year and assumed financial responsibility for the expenses of the tree farm. K also reported his income from the tree farm as earned income for purposes of the tax on self-employment income. Over a period of several years, K had harvested and marketed timber from certain tracts of the tree farm and had supervised replanting of the areas where trees were removed. K's history of harvesting, marking, and replanting of trees showed him to be in the business of tree farming rather than merely passively investing in timber land. If the history of K's tree farm did not show such an active business operation, however, the tree farm would not qualify for special use valuation. In light of all these facts, K is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment.

**The Sherrod case**—The above forestry example from the IRS regulations has been considered in at least one court decision [*Estate of Sherrod, H.F. v. Commissioner*, 82 TC 523; reversed on other grounds, 774 F2d 1057 (CA-11), 85-2 USTC ¶13,644]. At death, the decedent, Sherrod, was the beneficial owner of nearly 1,500 acres of land. During the last 25 years of his life, 1,108 acres were in timber, 270 acres in row crops, and 100 acres in pasture. All of the land was under the exclusive management and control of the decedent until 5 years before his death, when he put the property into a revocable living trust. Thereafter, until the decedent's death, management and control were exercised by the decedent's son, who was one of the trustees. Management activities included: (1) negotiation of annual rental payments on the crop and pasture lands; (2) contact from time to time with tenants and neighbors to check tenant performance and to see if they were aware of any problem with respect to the timberland; (3) supervision of the timberland by personal inspection, and contact with the

tenants and adjoining landowners to protect against trespass, insect infestation, and disease; (4) negotiation of timber-cutting contracts; and (5) payment of property taxes. Timber harvesting consisted of selection cutting; all regeneration was natural. The decedent personally supervised all logging by the timber purchasers.

The IRS argued that these activities did not rise to the level of a qualified use and material participation because they did not include construction of fire lines, pruning dead and undesirable growth, and thinning, citing the forestry example in the IRC section 2032A material participation regulations. The Tax Court, however, held that the activities of the decedent and his son did constitute a qualified use and material participation because they had made every managerial decision and had performed every act necessary to carry on the business for the last 25 years. That these activities did not require a great deal of time, were not extensive, and did not conform in a number of respects to the forestry example in the IRS regulations was immaterial. The Court concluded that the activities cited by the IRS as lacking were not practical or financially feasible with respect to the property in question—that management actions taken on one forest property are not necessarily those required for good management of another.

**The Mangels case**—Forest land material participation has been considered in at least one other court decision [*Mangels, R.W. v. United States*, 632 F Supp 1555 (DC-IA), 86-2 USTC ¶13,682]. Here, for 6 years before the decedent's death, her conservator, a bank, leased her forest land and pasture on a cash basis to parties unrelated to her. The issue was whether the material participation test was met. The Court, holding for the government, ruled that it was not met. The conservator's participation in the operations of the property was insufficient to satisfy the threshold requirements for material participation. No agent of the conservator did physical work on the property, and participation in management decisions was minimal.

### The 50- and 25-Percent Tests

Several important considerations must be kept in mind with respect to meeting the 50- and 25-percent tests. The determination of sufficiency of property for both tests is based on fair market value, minus mortgages and related liens. Increasing an existing mortgage or taking out a new one on property previously qualified for special use valuation could cause the net value to drop below one or both of the percentage thresholds.

**Partial election**—The special use valuation election does not have to be made for all the qualified property used to satisfy the 50-percent test. The 25-percent test, however, must be met from property actually elected for special use valuation.



**Gifts within 3 years of death**—Nonqualified property cannot have been gifted by the decedent within 3 years of death in order to meet the 50- or 25-percent eligibility tests. Any transfer of property within this time period will be includable in the gross estate for the limited purpose of determining the estate’s qualification for special use valuation.

**Example 12.2.** Mr. Tree Farmer, a widower, owns a tree farm with a fair market value of \$1.4 million and a special use value of \$700,000. His other assets, which are not eligible for special use valuation, have a fair market value of \$1.6 million. He has no debts. The adjusted estate thus has a fair market value of \$3 million. On this basis, the tree farm cannot qualify for special use valuation because its fair market value is only 46.7 percent ( $\$1,400,000 \div \$3,000,000$ ) of the fair market value of the total estate. Assuming no change in asset value, \$1 million would be subject to Federal estate tax at Farmer’s death. With the special use valuation percentage requirements in mind, Farmer gifts \$500,000 of securities to his only child. The gift uses up \$500,000 of his \$1 million lifetime exclusion amount for gifts and also reduces his estate exclusion at death by \$500,000. The fair market value of the estate is now \$2.5 million with the tree farm’s fair market value comprising more than half. Farmer gives a sigh of relief; he has just saved \$270,000 in Federal estate taxes—or so he believes. Unfortunately, Farmer has a heart attack and dies 24 months after making the gift. The value of the gift, therefore, will be brought back temporarily into his estate for the purpose of determining whether the special use valuation percentage requirements have been met. On this basis, the fair market value of the tree farm as a percentage of total fair market estate value again drops below 50 percent. Eligibility for special use valuation has been lost, and the estate is liable for an additional \$270,000 in unanticipated Federal taxes. If Farmer had died more than 36 months after making the gift, special use valuation could have been elected.

## Election and Agreement

When making the special use valuation election and signing the accompanying agreements, attention to detail is necessary. Many elections have been voided because of carelessness.

### Election

The election for special use valuation is made on IRS Form 706, United States Estate (and Generation-Skipping) Tax Return, Schedule A-1, Part 1 (see appendix II) by checking

the box marked “yes” in the “Elections by the Executor” section of the form. For forest properties, a second election also is necessary if standing timber in addition to the land is specially valued. This is made by checking the woodlands election box in Schedule A-1, Part 2, line 11. These elections may be made on a late-filed return if it is the first return filed. The Fifth United States Circuit Court of Appeals has upheld a denial by the Tax Court of an estate’s attempt to make a section 2032A election during the computational phase of its negotiations with the IRS because both parties had previously stipulated to the value of the underlying property with no mention of or claim to section 2032A valuation [*Estate of Kokernot, G.E.R. v. Commissioner*, 112 F3d 1290 (CA-5), 97-1 USTC ¶60,276; affirming TC Memo 1995-590].

In order to validate the election, an estate must complete and file Schedule A-1 and attach all of the required statements and appraisals. Schedule A-1 contains the “Notice of Election” and the “Agreement to Special Use Valuation.” The “Notice of Election” provides the fair market value of the property to be specially valued, its special use valuation, and the method used for computing the special use value. An estate may elect special use valuation for less than all of the qualified property included in the gross estate. As noted above, however, real property for which an election is made must have an adjusted value of at least 25 percent of the adjusted value of the gross estate. See, however, *Miller, M.S. Executor*, 680 F Supp 1269 (DC-IL), 88-1 USTC ¶13,757, holding the governing regulation for this rule [Treasury Regulation 20.2032A-8(a)(92)] invalid insofar as it imposed an additional substantive requirement to the statutory rules governing qualification for special use valuation. If an estate contains both property that qualifies for special use valuation and property that does not, and alternate valuation is elected (valuation as of six months after the decedent’s date of death; see chapter 3), the estate must determine the special use value (if elected) as of the alternate valuation date (Revenue Ruling 88-89, 1988-2 C.B. 333).

**Corporate and partnership interests**—For a decedent’s partnership interest in qualified property to be eligible for the special use valuation election, one of two requirements must be met: (1) the partnership must have had 15 or fewer partners, or (2) 20 percent or more of the partnership capital interest (see chapter 15) must be in the decedent’s estate. Eligibility requirements for corporate interests are similar: (1) the corporation must have had 15 or fewer shareholders, or (2) 20 percent or more of the voting stock must be included in the decedent’s estate.

**Protective election**—When it is uncertain whether real property meets the requirements for special use valuation, or if there is the risk that values may be substantially raised upon IRS examination of the return, the estate executor may



make a protective election to specially value some or the entire qualified property contingent upon property values as finally determined. The protective election is made by filing a notice of protective election with a timely filed estate tax return. If it is finally determined that the property qualifies for special use valuation, the estate must file an additional notice of election within 60 days of the determination. In 1997, the Fifth United States Circuit Court of Appeals held that an estate which had made a protective special use valuation election must make a final election within 60 days of the issuance of a deficiency notice by the IRS *Estate of Kokernot, G.E.R. v. Commissioner*, 112 F3d 1290 (CA-5), 97-1 USTC ¶60,276; affirming TC Memo 1995-590.

**Technically defective elections**—TRA eased the rules for correcting incomplete special use valuation elections [IRC section 2032A(d)(3), as amended by TRA]. For estates of decedents dying after August 7, 1997, if the executor files a timely notice of election and a recapture agreement, but the forms do not contain all the required information or the signatures of all persons required to sign, the executor has a reasonable time (not exceeding 90 days) after being notified by the IRS to provide the missing information.

### The Agreement

The “Agreement to Special Use Valuation,” which is Part 3 of Schedule A-1 of the Federal estate tax return (see appendix II), must be signed by each person having an interest in the qualified real property for which the election is made. It does not matter whether any of these persons is in possession of the property or not. In the case of a qualified heir, the agreement expresses consent to personal liability for any additional estate tax that may become due in the event of recapture due to any of the post-death requirements (discussed below) not being met. Signees other than the qualified heirs are not personally liable but must express consent to collection of any such additional tax from the qualified property.

**Corporate and trust interests**—Corporate interests cannot be valued under special use valuation unless the agreement contains a signature that binds the corporation; signatures by shareholders or heirs in their individual capacities are not enough (Technical Advice Memorandum 8602007, September 7, 1985). Similarly, a decedent’s interest that passes to a testamentary trust is not eligible for special use valuation unless the trust beneficiaries consent to be personally liable for any recapture tax; the trustee’s signature alone is insufficient (Technical Advice Memorandum 8802005, September 29, 1987).

**Tenants in common**—The Tax Court has held that the IRS regulation governing the signing of the agreement is invalid insofar as it requires that all individuals having

tenancy in common interests in property subject to a special use valuation election sign the agreements. The Court noted that the surviving tenants in the situation in question did not have “an interest in the property” because only the decedent’s tenancy in common interest was includable in his gross estate and thus subject to the election (*Estate of Pullin, M.F.*, 84 TC 789, CCH Dec. 42,060).

## Valuation

In making the election, two valuations must be determined for the affected property: special use value and fair market value. Both must be reported on the estate tax return. With respect to forest land, either bare land or standing timber or both may be specially valued. Often, however, it is only by including some or all of the standing timber on the property that both the 50- and 25-percent tests can be met. For a discussion of the procedures applicable to fair market valuation of forested property, see chapter 4.

### Alternate Valuation

As discussed above, when an estate elects to use the alternate valuation date of 6 months after the date of the decedent’s death (see chapter 3) and also elects special use valuation, the special use value must be determined as of the alternate valuation date. The alternate valuation date also must be used when determining whether the aggregate decrease in value of the qualified property exceeds the statutory dollar limit (Revenue Ruling 88-89, 1988-2 CB 333).

### Special Use Valuation of Forest land

Forest land special use valuation procedures must, for the most part, follow the general special use valuation rules applicable to farms, as set out in the IRS regulations. No valuation procedures specifically applicable to forest land are provided. Two methods of farm valuation are described: the “farm” method and the “multiple factors” method.

**Farm method**—The farm method is the preferred IRS special use valuation method. It is determined by dividing the average annual gross cash rental for comparable land used for the same purpose and located in the same locality, less the average annual property tax for such land, by the average annual effective interest rate for all new Federal Land Bank loans. The average annual computations are to be made on the basis of the five most recent calendar years ending before the date of the decedent’s death.

Forest land in the South sometimes is specially valued under the farm method by using rental payments specified in long-term leases to forest product companies, when the details of

such leases for comparable forested properties can be obtained.

Two recent court decisions have addressed using the “farm method” for special use valuation of forest land. Both decisions provide a good discussion and analysis of the statutory requirement that identified leased properties used in the section 2032A valuation process must be comparable to the estate forest land (see *Estate of Thompson, L.S. III v. Commissioner*, TC Memo. 1998-325, 76 TCM 426, and *Estate of Rogers, C.J. et al. v. Commissioner*, TC Memo. 2000-133, 79 TCM 1891).

Historically, the farm method has been used only for specially valuing the underlying land and not the standing timber. Most existing long-term leases encompass only land rental; some, however, provide for rental jointly of both land and timber. In the Rogers case, above, the Tax Court permitted the farm method of valuation to be applied to both land and timber in the estate because both were the subjects of the leases that were used by the estate. In addition, over IRS objections, the Court allowed the estate to use existing leases that had been initiated many years prior to the decedent’s date of death. The IRS position was that only leases entered into during the previous 5 years could be used. The Court noted that this proposed rule would eliminate the use of the farm method of valuation for forest land in Alabama, since virtually no timber leases had been initiated in the State since the early 1970s.

If no comparable land can be identified for which the average annual gross cash rental can be determined, the farm method may be used by substituting the average annual net share rental. Obviously, this has no applicability to forest land.

**Multiple factors method**—As an alternative to the farm method, if no comparable rented forest land can be documented, the executor may elect to value the property using the multiple factors method. The regulations list the following factors: (1) capitalization of income that the property can be expected to yield over a reasonable period of time under prudent management, taking into account the soil and other features affecting productivity; (2) capitalization of the fair rental value of the land for farming purposes; (3) the assessed property tax value in a State that provides differential or use value property tax assessment procedures for rural land; (4) comparable sales of other property in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sale price; and (5) any other factor which fairly values the farm value of the property. The Tax Court has held that if an estate that has elected special use valuation has not provided all of the necessary documentation to use the farm method, it is deemed to have,

by default, elected to use the multiple factors method [*Estate of Wineman, R.A.*, 79 TCM 2189, CCH Dec. 53,925(M), TC Memo. 2000-193]. Although not addressed in the section 2032A regulations, or administratively by the IRS, authors Siegel and Haney have been successful in applying the multiple factors method to standing timber separately from the underlying land.

The IRS has ruled that, when using the multiple factors method, the executor cannot select only one of the factors enumerated above as the exclusive basis of valuation unless none of the other factors is relevant. Each factor relevant to the valuation must be applied, although certain factors can be weighed more heavily than others, depending on circumstances (Revenue Ruling 89-30, 1989-1 CB 274).

**Change in method**—All special use property in the estate must be valued using either the farm method or the multiple factors method; one segment may not be valued by one method and another segment by the other. The IRS, however, has ruled that an estate that had made a valid special use valuation election could amend the election in order to substitute the farm method of valuation for the multiple factors method that was originally applied. The executor valued the decedent’s farm under the multiple factors method because he was unable to obtain the information (rentals for comparable farmland) necessary for computing value under the farm method until after the return was filed. Although the special use valuation election is irrevocable, the IRS did not bar the estate from changing the method of valuation once the election was made. In addition, the IRS noted that a change from the multiple factors method is allowable even where information regarding comparable farmland is available, but the executor nevertheless originally applies the multiple factors method (Revenue Ruling 83-115, 1983-2 CB 155).

**Technical advice memorandum 9328004 (March 31, 1993)**—The IRS addressed the valuation method for special use valuation purposes for a Douglas-fir tract included in a decedent’s estate. The executor used the farm method, citing a single property in the area that included forest land and was leased on a cash basis. The IRS ruled that the two properties were not comparable and that the executor thus was required to use the multiple factors method of valuation. The memorandum discusses at length the applicability of the multiple factors method to forest land and how it should be used to specially value forest property.

**Forest land special use valuation**—The special use valuation election for forest land is directed toward limiting the highest and best use of such acreage to timber growing. The election is designed to eliminate purely speculative and inflationary components of value, even when timber production is the highest and best use. Factors 1, 3, and 4 in

the “Multiple Factors Method” section, above, are the most applicable to forest land; of these, income capitalization and property tax values probably are used the most often. Depending on the circumstances and characteristics of the property involved, the multiple factors method of valuation may result in a value lower than the current market value for timber use—a result specifically permitted by the regulations.

### Other Valuation Considerations

**Applicability of minority discounts**—In 1995, the Tenth United States Circuit Court of Appeals, reversing the Tax Court, held that the maximum reduction in value (then \$750,000) of qualified real property imposed by section 2032A can be subtracted from the true fair market value of a minority interest in that property when said fair market value is calculated by employing a minority discount factor. The Appeals Court rejected Tax Court and IRS reliance on *Estate of Maddox, F.E.W. v. Commissioner*, [93 TC 228 (1989), CCH Dec. 45,924], noting that *Maddox* did not involve the \$750,000 limitation but rather the estate’s attempt to reduce further the reported special use value by applying a minority interest discount to it as opposed to the fair market value [*Estate of Hoover, K.C. v. Commissioner*, 102 TC 777, CCH Dec. 49,919; reversed 69 F3d 1044 (CA-10), 95-2 USTC ¶60,217].

**Discounts based on the recapture provisions**—In a 1999 field service advice, the IRS concluded that the section 2032A recapture provisions (see below) don’t apply to reduce the timber’s value. In valuing the timber under the multiple factors method, an estate’s appraiser estimated no timber income for the first 10 years based on the recapture provisions and took this into account under valuation factors 1 and 5. See IRS Field Service Advice 199924019 (March 17, 1999, <http://www.unclefed.com/ForTaxProfs/irs-wd/1999/9924019.pdf>).

### Postdeath Requirements

Certain requirements must continue to be met during a 10-year recapture period measured from the decedent’s date of death. However, the qualified heirs have a maximum 2-year grace period from that date to begin the qualified use and material participation. The 10-year period is extended by whatever portion is used of the 2-year grace period.

### Continued Ownership Within the Period

Ownership of the specially valued property must continue solely within the decedent’s family, as the term “family members” is defined above. Exceptions apply to involuntary conversions or tax-free like-kind exchanges. With respect to the former, however, the proceeds from the involuntary

conversion must be reinvested in real property that is used for the same qualified use as was the involuntarily converted property. Similarly, property received in a like-kind exchange also must be employed in the same qualified use.

### Material Participation

If the qualified heir should die during the 10-year period following the initial decedent’s death, at least one member of the initial decedent’s family, as defined above, must materially participate in operation of the property during 5 of every 8 years. The less stringent active management test—described in the “Material Participation” section, above—may be used to meet the material participation requirement for the surviving spouse, qualified heirs under the age of 21, full-time students, or disabled persons. If the property in question has been left in a trust to which the surviving spouse is the life beneficiary and other qualified heirs are the remaindermen, the surviving spouse is the qualified heir for purposes of compliance with the material participation requirements (Private Letter Ruling 8652005, September 12, 1986).

### Qualified Use

The property must continue to be used and managed for the qualified use. As noted above, however, a qualified heir may begin the qualified use at any time within 2 years of the decedent’s death without triggering the recapture tax (see below); the recapture period does not begin to run until the qualified use begins. If property is left in a trust to which the surviving spouse is the life beneficiary and other qualified heirs are the remaindermen, the spouse is the qualified heir for purposes of compliance with the qualified use test (Private Letter Ruling 8652005, September 12, 1986).

### Recapture Tax

The tax benefits realized by the estate when special use valuation has been elected may be fully or partially recaptured if one of the post-death requirements discussed above fails to be met during the recapture period. A second violation will not trigger a second tax on the same qualified property, however. Thus, if a qualified heir ceases to use the property for its qualified purpose and later sells it during the recapture period, a recapture tax will be imposed as to the first event that triggers recapture—that is, cessation of use—but not as to the second event—the sale of the property.

### Special Considerations

**Conservation reserve program enrollment**—Private Letter Ruling 8745016 (August 7, 1987), discusses diversion of cropland to tree cover under the Conservation Reserve

Program (CRP). Here, the qualified heir for specially valued farmland converted the farmland from crops to tree cover after enrolling in the CRP program. The IRS ruled that such diversion is not a cessation of qualified use so as to trigger the recapture tax.

**Conservation easements**—Contribution of a qualified conservation easement does not constitute a discontinuance of qualified use [IRC section 2032A(c)(8)], as amended by TRA. However, the sale of a conservation easement during the recapture period is deemed by the IRS to be a disposition of the specially valued property, which triggers the recapture tax. The IRS holds to this position despite at least one court decision to the contrary.

**Lease of qualified property**—Under a provision added by TRA, a surviving spouse or lineal descendant of the decedent no longer is treated as failing to use qualified real property in a qualified use solely because the spouse or lineal descendant rents the property to a member of the family of said spouse or descendant on a cash basis [IRC section 2032A(c)(7)(E), as amended by TRA section 504 (a)].

### Amount Subject to Recapture

The amount of the tax benefit potentially subject to recapture is the estate tax liability that would have been incurred had the special use valuation procedure not been used, minus the actual estate tax liability based on special use valuation. In other words, the maximum additional or recapture tax is the amount of tax that electing special use valuation saved the estate. This is called the adjusted tax difference. The additional tax will be less than the maximum if the fair market value of the property interest in question—or the proceeds from its arms-length sale—exceeds the value of the property interest determined under special use valuation by less than the adjusted tax difference.

### Payment of the Recapture Tax

The additional tax on recaptured property is due on the day that is 6 months after the recapture event. Interest runs from the due date (Revenue Ruling 81-308, 1981-2 CB 176). If, however, an election is made to adjust the basis of the property in question to its fair market value on the date of the decedent's death, interest is owed from the due date of the estate tax return. Such an election is permitted under IRC section 1016(c). If interest is paid, it is not deductible by the original estate as an administrative expense; the IRS reasons that the recapture tax and the interest on it is not imposed in connection with a testamentary transfer of estate property, but rather is a separate tax imposed on the qualified heir as a result of the heir's own actions (Private Letter Ruling 8902002, September 26, 1988).

### Recapture Lien

A government lien is imposed on all qualified property for which a special use valuation election has been made and applies to the extent of any recapture tax that may be imposed. The lien begins at the time the election is filed and continues until: (1) the tax benefit is recaptured; (2) the qualified heir either dies or the recapture period ends; or (3) it can be established to the satisfaction of the IRS that no further liability will arise. If qualified replacement property is purchased following an involuntary conversion of special use valuation property, the lien that was applicable to the original property attaches to the new. Similarly, if specially valued property is exchanged for qualified property, the lien also attaches to the new property. The IRS can subordinate the government's lien if it determines that the interest of the United States will be adequately protected thereafter.

### Release from Recapture Tax Liability

A qualified heir is personally liable for that portion of the recapture tax imposed with respect to his or her interest in the specially valued property. Liability for the recapture tax can be extinguished in three instances: (1) if the recapture period lapses, (2) if the heir dies without converting or disposing of the property, or (3) if the tax benefit is recaptured. Additionally, a sale or other disposition by one qualified heir to another of specially valued property is not considered a recapture event, and the second heir is treated as if he (she) received the property from the decedent rather than from the first heir. The second heir then becomes liable for the recapture tax, and the seller is released from further liability. Even if the second heir has paid full consideration for the property, the special estate tax lien remains.

**Discharge from liability**—An heir may be discharged from personal liability for future potential recapture taxes by furnishing a bond for the maximum additional tax that could be imposed on his (her) interest in the property. The qualified heir must make written application to the IRS for determination of the maximum additional tax. The IRS, then, is required to notify the heir within 1 year of the date of the application as to the maximum amount.

### Timber and the Recapture Tax

Unfortunately, an onerous special rule applies to the cutting of specially valued timber during the recapture period. Any harvesting of such timber or the transfer to another of the right to harvest before the death of the qualified heir will be termed a disposition of the interest in the specially valued timber, and will trigger a recapture tax. The recapture amount will be the lesser of: (1) the amount realized on the disposition (or if other than a sale or exchange at arm's length, the fair market value of the portion of the



interest disposed of), or (2) the amount of tax that would be recaptured under the general recapture rules, without regard to the woodland election, were the entire interest in the qualified forest land to be disposed of. The second of these requires that the computation be made as if there had been a disposition of the land as well, even though it is not actually disposed of.

The valuation of severed specially valued timber for recapture tax purposes is discussed in detail in a 1983 Tax Court decision [*Peek, D.C. v. Commissioner*, TC Memo. 1983-224, 45 TCM 1382, CCH Dec. 40 40,063(M)]. Calculation of the recapture tax with respect to the sale of a tract of farm and forest property is set out in Private Letter Ruling 8741048 (July 14, 1987).

**Designation of specially valued timber**—In most instances, executors probably will choose not to specially value standing timber—except as needed to meet the 25- or 50-percent qualifying tests—when there is other property included, such as the underlying forest land and/or farm acreage. Obviously, young timber that would not be harvested during the 10 year recapture period should be used first for the special use valuation election. The designation should be made on an acreage basis, if possible, to avoid confusion as to just which trees are included. For the same reason, if older timber is to be specially valued, it also would be most feasible to do it on an acreage basis, with a specific description of the acres containing the trees to be so valued.

Alternatively, the distinction could be made by species or diameter classes as they exist at the time of the election, but a very careful description would be required. Specially valuing a certain percentage of a stand's volume—for example, 50 percent of the merchantable volume that exists in a stand at the time of election—should be avoided. A situation was related to the authors in private correspondence

where this was done. The IRS accepted the election, but when the executor decided to harvest some of the trees and sought clarification from the IRS as to which trees could be cut, he was confronted with an unexpected problem. The executor wanted to cut the number of trees whose volume would equal the percentage of original stand volume not specially valued. The IRS, however, took the position that the volume breakdown applied to each tree—not to the stand as a whole—and therefore, part of each tree was specially valued. This meant that no trees whatsoever could be cut without constituting a premature disposition and triggering a recapture tax.

## The Election Decision

Like many other provisions that grant tax relief in particular situations, special use valuation should not be elected without careful thought and analysis. The executor has an obligation to evaluate the election because of its potentially significant impact on estate tax liability, and such an evaluation should not be avoided merely because it may be difficult and complex. Like many other provisions of tax law, its effects can be assessed only through mathematical application to the circumstances of the particular estate in question.

The election may be used on a partial basis to control the valuation of only part of the estate, such as the property for which the greatest reduction in per-acre value may be achieved, while leaving other property to conventional valuation. Depending on the size and nature of the estate, land that will provide the maximum value reduction may be selected from property intended to be retained by the family, while preserving other property for future liquidation, if desired.

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## Chapter 13

### Deferral and Extension of Estate Tax Payments

#### Overview of the Estate Tax

The estate tax is due and payable at the same time the estate tax return is due, that is nine months after the decedent's date of death. It must be paid within the time prescribed to avoid assessment of interest and penalties. Extensions of time for payment may be granted, but such extensions—although preventing the application of certain penalties—do not entirely negate the assessment of interest.

#### Due Date

The payment due date is the same numbered day of the ninth month after the date of death as that date was of the month in which death occurred. If there is no similarly numbered day in the ninth month, the tax is deemed to be due on the last day of that month. For example, if the date of death were July 31, the due date would be April 30 of the following year.

#### Place of Payment

The law requires that the tax be paid, without any assessment or notice by the Internal Revenue Service (IRS), to the IRS office where the estate tax return is filed. Unless the return is hand carried to the office of the IRS District Director, it should be mailed to the IRS Service Center for the State in which the decedent was domiciled on the date of death.

#### Method of Payment

The tax may be paid by check or money order payable to the U.S. Department of Treasury. If the amount of tax paid with the return is different from the amount of the net estate tax payable as computed on the return, the executor should explain the difference in an attached statement.

#### Flower Bonds

Treasury bonds of certain issues known as “flower” bonds are redeemable at par (plus accrued interest from the last preceding date to the date of redemption) upon the death of the owner, at the option of the estate representative. No treasury obligations issued after March 3, 1971 will be redeemable at par value for this purpose.

#### Estate Tax Option for Closely Held Business Interests

The estate of an individual who dies owning a closely held business interest (discussed below)—including an interest in forest land—may, by meeting certain requirements, qualify for a special elective method of paying the estate tax attributable to that interest. Under section 6166 of the Internal Revenue Code (IRC), payment of the tax may be totally deferred for the first 5 years, with the estate making 4 annual payments of interest only, followed by payment of the balance in up to 10 annual installments of principal and interest. The maximum payment period, however, is 14 rather than 15 years because the due date of the last payment of interest only coincides with the due date for the first installment of tax. Election of special use valuation as discussed in chapter 12 does not prevent an election under section 6166.

#### Percentage Test

The closely held business interest(s) must comprise more than 35 percent of the decedent's adjusted gross estate. The interest(s) can be composed entirely of forested property or partially include forest land, but must be active businesses. Investment property will not qualify. If special use valuation has been elected by the estate (see chapter 12), that value is used for purposes of determining whether the 35-percent test has been met.

**Mortgage effects**—Insofar as the eligibility of a business ownership interest as a percentage of the decedent's adjusted gross estate is concerned, mortgages secured by real property used in the business must be deducted. Eligibility is measured in terms of the net value of the property in question and whether that value meets the 35-percent threshold requirement. Private Letter Ruling 8515010 (January 8, 1985) discusses the effect of a mortgage that encumbers both property used in the closely held business and other property. The IRS here ruled that the gross value of the decedent's closely held timber growing business had to be reduced by that portion of the outstanding mortgage attributable to it for purposes of valuation under the section 6166 installment provisions. The mortgage in question encumbered both timberland and pasture. The rental of the pasture by the decedent was determined to be a passive activity, not the conduct of an active business. The



timberland was held to be an active business, however, and an allocation of the mortgage between it and the pasture on the basis of acreage was therefore necessary.

**Combining interests**—Interests in two or more closely held businesses may be combined for purposes of meeting the 35-percent test if more than 20 percent of the value of each is included in the gross estate. The value of a surviving spouse's interest in property held as tenancy in common, tenancy by the entirety, joint tenancy, or community property will be counted in determining whether more than 20 percent of the business was owned by the decedent.

### Interest Payable on Deferred Tax

Interest on deferred tax is payable at a special 2-percent rate, compounded daily, on the portion attributable to the first \$1 million of taxable value (the first \$1 million in excess of the effective exclusion amount provided by the unified credit) of the closely held business. Since 1999, the first \$1 million has been indexed for inflation. The taxable value in 2008 subject to the 2-percent interest rate is \$1,280,000. That means that for 2008, the maximum amount of tax eligible for the 2-percent rate is \$576,000 (\$1,356,800 tentative tax on \$3,280,000, less the applicable unified credit of \$780,800). On the excess, the rate is 45 percent of the rate charged by the IRS for late tax payments. The interest paid is not deductible for either income or estate tax purposes.

### Making the Election

The section 6166 election must be made on a timely filed estate tax return containing the following information: (1) the decedent's name and taxpayer identification number; (2) the amount of the tax to be paid in installments; (3) the date elected for payment of the first installment; (4) the number of annual installments, including the first installment, in which the tax is to be paid; (5) the properties shown on the estate tax return that constitute the closely held business interest; and (6) the facts supporting the conclusion that the estate qualifies for the deferral and installment election.

**Subsequent deficiencies**—If the election is made at the time the estate tax return is filed, it will also cover subsequent estate tax deficiencies determined by the IRS that are attributable to the closely held business. This is in addition to the estate tax originally due with the return as filed.

**Protective election**—If it is uncertain at the time of filing the return whether the estate qualifies for the election, a protective election can be made. It will allow subsequent deferral of any portion of the tax attributable to the closely held business that is shown on the return, or deferral of deficiencies remaining unpaid at the time values are finally

determined. The protective election must be made on a timely filed return. A final election notice then must be filed within 60 days after it has been determined that the estate qualifies for the election [Treasury Regulation 20.6166-1(d)].

**Another alternative**—Even if a regular or protective election was not filed, the executor of an estate can obtain a general extension of time for payment of the estate tax for a period not to exceed 12 months from the date fixed for payment of the tax, if it can be shown that "reasonable cause" exists for granting the extension [IRC section 6161(a)]. An additional discretionary extension of time to pay also may be allowed for reasonable cause; the time for payment under such an extension may be deferred for a period not to exceed 10 years [IRC section 6161(a)(2)]. Reasonable cause [Treasury Regulation 20.6161-1(a)(1) and Instructions for IRS Form 4768 (Revised January 2007), Part III, p. 3] will exist under any of the following circumstances: (1) the estate consists largely of a closely held business or farm and does not have sufficient funds to pay the tax on time; (2) the estate is unable to gather sufficient liquid assets because of legal difficulties; (3) the assets consist of annuities, royalties, contingent fees, or accounts receivable that are not collectible by the due date; (4) litigation is required to collect assets in the decedent's estate; (5) the estate must sell assets to pay the tax at a sacrifice price or in a depressed market; (6) the estate does not—without borrowing at a rate of interest higher than that generally available—have sufficient funds to pay the entire tax and at the same time also provide for the surviving spouse's and children's allowances and outstanding claims against the estate; or (7) the estate's liquid assets are located in several jurisdictions and are not immediately subject to the executor's control.

### Acceleration of Unpaid Taxes

Deferred tax payments are accelerated if more than one-half of the value of the qualified business interest(s) is withdrawn or disposed of during the deferral period. See below for a discussion of what constitutes a withdrawal or disposal. The same rule applies if funds or assets are withdrawn that represent 50 percent or more of such value. For this purpose, values are measured as of the date of the withdrawal(s), not the date of death.

**Death of original heir**—The transfer of the decedent's interest upon the death of the original heir, or upon the death of any subsequent transferee who has received the interest as a result of the prior transferor's death, will not cause acceleration of taxes if each subsequent transferee is a member of the transferor's family. IRC section 267(c)(4) defines family members as brothers and sisters (whole or half blood), spouses, ancestors, and lineal descendants.

**Delinquent payments**—A delinquent payment of either interest or tax will accelerate the due date of the unpaid tax balance if the full delinquent amount is not paid within six months of its original due date. The late payment, however, will not be eligible for the special 2-percent interest rate. Additionally, a penalty of 5 percent per month of the amount of the payment will be imposed.

### Liability for Payment of the Tax

With a section 6166 election, the estate representative basically is liable for payment of the tax. However, an executor or administrator seeking discharge of liability may file an agreement that gives rise to a special estate tax lien. The lien is against “real and other property” expected to survive the deferral period. The maximum amount subject to the lien is the amount of deferred tax, plus the first 4 years of interest. All parties having an interest in the property to which the lien is to attach must sign an agreement to its creation.

Once filed, the lien is a priority claim against the property, with some exceptions: (1) real property tax and special assessment liens; (2) mechanics’ liens for repair or improvement of real property; (3) real estate construction or improvement financing agreements; and (4) financing for the raising or harvesting of a farm crop, or for the raising of livestock or other animals.

### What Constitutes a Closely Held Business Interest?

**Sole proprietorship**—A sole proprietorship (see chapter 14) may qualify as a closely held business. Assets, including cash, must actually be involved in the trade or business of the sole proprietorship before their value can be included. Passive assets held by a sole proprietorship are not considered in determining value.

**Partnership**—If certain rules are met, a partnership interest (see chapter 15) may qualify. Either 20 percent or more of the partnership’s total capital interest at the time of the decedent’s death must be included in the decedent’s gross estate or the total number of partners must not exceed 45. Inclusion of the value of passive assets held by a partnership is disallowed for purposes of the 35-percent test. Partnership interests held by members of a decedent’s family (as defined above) are treated as if owned by the decedent for purposes of the 35-percent test. A husband and wife are considered as one partner if the property is held as community property, tenancy in common, joint tenancy, or tenancy by the entirety (see chapter 14).

**Corporation**—A corporate interest (see chapter 16) also may qualify as an interest in a closely held businesses.

For a corporate interest to qualify, however, 20 percent or more of the corporate voting stock must be included in the decedent’s gross estate or the total number of shareholders must not exceed 45. Only stock constitutes an interest in a corporate closely held business; corporate debt securities are not interests. It is not necessary that the shareholder decedent have been personally involved in the business in order for his (her) stock ownership to qualify under section 6166. As with a partnership, corporate interests held by a decedent’s family, as defined above, are treated as if owned by the decedent for purposes of the 35-percent test. A husband and wife are treated as one shareholder if the stock is held as community property, tenancy in common, joint tenancy, or tenancy by the entirety.

**Special attribution election**—A special attribution-of-ownership rule applies if the executor of the estate so elects. This rule provides that all non-readily tradable stock and all partnership capital interests of a decedent and the decedent’s family will be considered owned by the decedent for purposes of determining whether 20 percent of the corporation or partnership is includible in the decedent’s gross estate [IRC section 6166(b)]. Family members whose interests will be considered as held by the decedent are the same as defined above.

If the benefits of this rule are elected, the estate is deemed to have elected to pay the tax attributable to the business interest in 10 installments beginning on the due date for payment of the decedent’s estate tax; there is no deferral period. Additionally, the special interest rate applied under the regular deferral and installment election is not available [IRC section 6166(b)(7)(A)(iii)].

It should be noted that the stock or partnership interests attributed to a decedent under this rule are attributed only for the purposes of the 20-percent requirements. Thus, the value of the attributed stock or partnership interest is not included in the decedent’s gross estate for purposes of the 35-percent rule.

**Trusts**—The IRC installment payment provisions and IRS regulations do not refer specifically to trust ownership of an interest in a closely held business. The IRS, however, does recognize business interests in trust as qualifying under section 6166. For example, in Private Letter Ruling 9015003 (December 22, 1989) and supplementing Private Letter Ruling 9001062 (October 13, 1989), the IRS concluded that a decedent’s one-third interest in a timber business held in trust qualified as an interest in an active, closely held business for section 6166 purposes. The property was under active forest management, with daily operations and timber sales carried out by an independent forest management company. The decedent, individually and through her agents, participated in the decision-making process in running

the business. She and other grantors met annually with the trustee and a representative of the forest management company to review the prior year's forest management activities, to discuss plans for the coming year, and to make long-term plans. The decedent also shared equally with the other grantors the income from and the expenses of the business, and thus also shared in the risks involved. For purposes of IRC section 6166(a), activities of an agent may be attributed to a decedent. In this case, the trustee was the decedent's agent.

**Conservation reserve program enrollment**—The IRS has ruled that land entered into the Federal Conservation Reserve Program (CRP) was part of the decedent's farming business in determining whether the executor could elect deferral of estate tax under section 6166 (Private Letter Ruling 9212001, June 20, 1991). Although the decedent was engaged in the business of farming and cattle raising on other lands that she owned, she never had used the CRP land for commercial purposes—having purchased it after it already had been entered into the CRP. The IRS determined that participation in programs such as CRP does not disqualify the lands in question from section 6166 eligibility.

### What Constitutes Withdrawal or Disposition?

Changes in organizational form do not terminate the installment payment right if they do not materially affect the business. Thus, incorporation of a sole proprietorship, a shift from sole proprietorship status to partnership, liquidation of a corporation, and transfer of a sole proprietorship to a limited partnership all have been held not to accelerate payment. Incorporation of a sole proprietorship with issuance of corporate debentures, however, is a disposition as to the debt securities issued. An installment sale of property also will terminate section 6166 status if the 50-percent limit is reached.

Converting cropland for which a section 6166 election is in force to grass or tree cover under CRP is not a withdrawal or disposition (Private Letter Ruling 9212001, June 20, 1991). The tax attributable to the property will continue to be eligible for deferral and payment in installments.

**Like-kind exchange**—The transfer of assets in a tax-free exchange does not accelerate payment of tax that has been deferred. In Private Letter Ruling 8722075 (March 3, 1987), the IRS ruled that an estate's partition of an undivided interest in forest land, followed by a like-kind exchange, did not affect the section 6166 election that was

in force. Although more than 50 percent of the property may have been transferred—depending on whose values were accepted—the exchange did not materially alter the timber business or the estate's interest in the timber business. The partition and exchange was, therefore, not a disposition for acceleration purposes.

**Private letter ruling 8437043 (June 8, 1984)**—The IRS, here, held that a proposed sale of timber comprising 51 percent of the closely held business interests and a proposed 29-year lease of the land (comprising 35 percent of the closely held business interests) to a forest products company would constitute a disposition under IRC section 6166(g)(1) (A). The estate, according to the ruling, would be liquidating its active business enterprise of timber production in exchange for an arrangement in which it would merely hold the land as an investment asset from which income would be derived solely on the basis of ownership.

### Planning Opportunities

Because the value of the closely held business must exceed 35 percent of the adjusted gross estate, forest landowners seeking to qualify under section 6166 should be familiar with the various elements that constitute the adjusted gross estate. If the value of the tree farm is very close to 35 percent, consideration should be given to increasing its value or decreasing the adjusted gross estate during the decedent's lifetime. The types of expenses which may be deducted in order to reduce the adjusted gross estate are discussed in chapter 3.

Great care should be taken in deciding whether to make gifts of non-qualifying assets in order to qualify for section 6166 treatment. Gifts of such assets made within 3 years of death that normally would not be included in the gross estate will be considered in determining whether the 35-percent test is met. This provision was specifically designed to prevent deathbed transfers for the purpose of section 6166 qualification.

Special use valuation (see chapter 12) also should be carefully evaluated. While its use will decrease estate tax liability, it may preclude qualifying for installment treatment by lowering the qualified property's value below 35 percent of that of the adjusted gross estate. Under these circumstances, if only one or the other can be elected, the value of deferring the estate tax payments should be compared to the value of the estate tax reduction.

**PART IV**

**FORMS OF BUSINESS ORGANIZATION  
AND FOREST LAND OWNERSHIP**



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## Chapter 14

### Sole and Joint Ownership Considerations

#### Sole Ownership

Owning property in one name usually is the simplest method and gives the holder the most complete ownership possible. Transfers are relatively easy because, under most circumstances, the holder of title to the property has the absolute right to dispose of it as he (she) wishes—although in some States, one spouse may have to consent to the transfer of real property owned solely by the other because of the dower right available under State law. At death, solely owned property passes under provisions of the will, or if the decedent died intestate, according to the provisions of State law. Federal estate and State death taxes generally apply to the total value of the property held in sole ownership. Outright ownership of property is referred to as “fee simple,” the nearest thing to absolute and complete ownership. For business purposes, sole ownership, also called sole proprietorship, means an unincorporated business owned by a single individual.

#### Nonspousal Co-Ownership

Co-ownership is the undivided ownership of property by two or more persons. There are several recognized forms of nonspousal co-ownership.

#### Tenancy In Common

With the tenancy in common form of joint ownership, each person can sell or divide his (her) share and transfer his (her) interest as he (she) wishes. Upon the death of a tenant in common, that person’s undivided interest passes to his (her) heirs or legatees under State law and/or provisions of the will.

#### Joint Tenancy

Joint tenancy sometimes is referred to as joint tenancy with the right of survivorship. Some States do not recognize joint tenancy. In those States that do, a joint tenant can sell or gift his (her) interest, but cannot dispose of it by will. Upon the death of a joint tenant, that person’s undivided interest passes to the surviving joint tenant(s) without being subject to probate. Obviously, this is a fragile device for property ownership.

#### Advantages of Nonspousal Co-Ownership

In many States, the probate procedure is perceived to be so cumbersome, time consuming, and expensive that joint property holding (termed joint tenancy in most States) is common. Joint property holding tends to express the common feeling of joint endeavor and mutual accomplishment enjoyed by owners of farm, forest, and other rural properties. It commonly has been utilized as a substitute for more complex business organization arrangements.

Survivorship property ownership arrangements can offer each owner the emotional and financial security of knowing that the mutually acquired property cannot be lost by the survivor, in whole or in part, upon the death of the other. Additional advantages include the ease of understanding and implementing the concept, and the uncomplicated and inexpensive transfer process.

#### Disadvantages of Nonspousal Co-Ownership

Individuals often become involved in co-ownership without fully realizing what it means in terms of loss of freedom and control and the costs involved. Before or upon death, sales may be difficult to accomplish. One co-owner may want to sell, while the other(s) may not. If a partial sale of an undivided interest is made, the price realized may be less than the sale property’s proportionate share of the fair market value of the property as a whole.

**Unintentional termination**—In some States, joint tenancy ownership may be severed by a contract to sell to third parties or even by the placing of a mortgage on the property. As a result, the parties may fail to achieve their purpose through an unintentional termination of the survivorship feature.

**Limitation on using a disclaimer**—The role of disclaimers (see chapter 7) as a postmortem estate planning tool for jointly held property is extremely limited. Only a few States permit a disclaimer of the interest in joint-tenancy property that has been transferred to the survivor. Thus, this highly desirable method of postmortem tailoring of property ownership is not available if not provided for by State statute, and the resultant after-death tax planning generally is denied to the surviving joint tenant.



In general, for Federal estate tax purposes, an individual must make a qualified disclaimer of the interest to which the disclaimant succeeds on creation of a joint tenancy within 9 months after creation of the tenancy [Treasury Regulation 25.2518-2(c)(4)(i)]. It does not matter that a later disclaimer may be valid under State law. This position is based on the fact that the potential disclaimant accepted the property when the joint tenancy was created (Private Letter Rulings 7829008, April 14, 1978, 7911005, November 29, 1978, and 7912049, 1979); therefore it must be disclaimed within the statutorily required 9-month period.

In any case, a qualified disclaimer of the survivorship interest can be made no later than 9 months after the death of the first joint tenant to die. The timing for disclaiming the survivorship interest is not affected by the power of the disclaimant to unilaterally sever the tenancy under local law.

**Post-Death income tax considerations**—Another disadvantage of joint tenancy involves post-death income tax considerations. There are a great many advantageous income tax options available to the estate of a decedent. Because survivorship property passes to the survivor immediately upon the death of the decedent, however, there is no intervening estate to act as a taxable entity. Thus, the surviving joint tenant cannot take advantage of the postmortem tax options generally available to estates, although the non-spousal surviving tenant does receive a “stepped-up” basis for the deceased tenant’s share of the property.

**Real property considerations**—Most States with joint tenancy statutes now permit the creation of joint tenancies in real property by a conveyance to the joint tenant(s) that sets forth the existence of the survivorship feature. Income realized from such property is treated in most States as the separate property of the joint tenants in proportion to their ownership interests. Once established, however, ownership of the income resulting therefrom sometimes becomes an issue. The status of the income is critical to the tax consequences associated with it, particularly with respect to proof regarding contributions by a nonspousal donee or surviving joint owner.

**Federal estate tax aspects**—The estate tax consequences of the death of an individual who has an interest in a joint tenancy are governed by Internal Revenue Code (IRC) section 2040. Section 2040(a) applies to all situations involving nonspousal joint interests. The value of any such joint interest is to be included in the decedent’s gross estate to the extent of his (her) fractional share of the property in cases where: (1) the property was acquired by gift, bequest, devise, or inheritance, or (2) the property was acquired by other means, such as purchase, to the extent that it cannot be determined that the surviving tenant(s) provided

consideration for the acquisition of the property. Because it sometimes can be difficult to determine the amount of consideration provided by each tenant, it is very important that accurate records be kept when using nonspousal joint property holding arrangements.

## Spousal Co-Ownership

A key estate planning element for family-owned forest land is the manner in which the property is held by husband and wife. Typically, the spouses have worked together to accumulate and manage the forest land. The result is a feeling of commonality of ownership, and the intent that the property be controlled by and applied to the use of the survivor as long as he (she) lives.

It is beyond the scope of this book to provide a detailed discussion of the various methods of interspousal property holding among the 50 States. A basic analysis of the application of estate and gift taxes to property transfers within the marital community will, however, be presented.

## Legal Development

The traditional English concept of jurisprudence was that as long as both spouses lived, they represented a single unit of ownership, with this ownership being represented by the surviving spouse after the death of the other. A blending of this common law concept of the legal unit of husband and wife with the common law theory of joint ownership of property led to the development of tenancy by the entirety.

**Tenancy by the entirety**—Tenancy by the entirety is the joint ownership of real property by spouses with the right of survivorship. Its distinguishing feature is that no partition or severance of the survivorship can be achieved by the unilateral action of either spouse. Many States have abolished this concept as a form of holding real property; others have continued it, sometimes with modification.

**Abolishment of tenancy by the entirety**—Where tenancy by the entirety has been abolished, common law joint tenancy generally may be utilized to create property holdings between husband and wife that have the survivorship feature. Joint tenancy resembles tenancy by the entirety in that both entail a right of survivorship. Unlike tenancy by the entirety, however, joint tenancy additionally permits partition of the property at the will of any of the co-tenants.

## Federal Estate Tax Aspects

IRC section 2040(b) establishes the concept of a “qualified joint interest.” This concept is defined as “any interest in

property held by the decedent and the decedent's spouse as (1) tenants by the entirety; or (2) joint tenants with right of survivorship, but only if the decedent and his (her) spouse are the only joint tenants." For such an interest in property, the value to be included in the decedent's gross estate is one-half of the value of the interest.

### **Disadvantages of Spousal Co-Ownership**

Several of the disadvantages discussed above with respect to non-spousal joint interests also apply to spousal joint ownership. These include limitations on using a disclaimer and the absence of an intervening estate to take advantage of favorable income tax provisions. In addition, there is the particular disadvantage discussed in the next paragraph.

**Basis limitations**—Despite the valuable uses of joint property holding arrangements between spouses, there can be problems with respect to basis—particularly for those estates that have values greater than the applicable exclusion amount. Regardless of which spouse provided the consideration, when spouses are exclusively joint tenants in property, one-half of the value of the property is included in the gross estate of the first spouse to die. Although no Federal estate tax is paid on property passing to the surviving spouse because of the unlimited marital deduction, in non-community property States the surviving spouse may receive a stepped-up basis only in that property included in the gross estate of the decedent spouse, depending on how the joint ownership was structured. If the first spouse to die had owned all of the property, a full step-up would have been obtained.

### **Community Property**

Nine States—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—derive their concepts of property holding between husband and wife from the civil law rather than from common law. These are the so-called "community property States." The basic community property concept is that all property acquired by the spouses from the efforts of either during the marriage belongs in common to both. Separate property generally is that owned prior to the marriage or received individually through inheritance or gift.

Generally, in community property States, the surviving spouse is protected to a greater degree in succession to community property than in succession to separate property. At the death of the first spouse, the entire community property receives a stepped-up basis. As well, the profits and earnings from community property, and in some cases from separate property, are considered community property.

### **Life Estates**

A life estate is a limited property interest. The life tenant transfers title of the property to the remainder person, with retention by the transferor of the right to use, enjoy, and perhaps receive income from the property transferred for a term of years or for life. The life tenant has the right to possession of the property. His (her) responsibilities include such things as paying mortgage interest, paying property taxes, and keeping the property in good condition and protecting it. Many States have statutory provisions that require a life tenant whose tenancy includes forest land to practice sustainable forest management on the property. Acting alone, the life tenant generally cannot sell or mortgage the property except with the approval of the remainder person.



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## Chapter 15

### Partnerships

Most family forest land traditionally has been operated as sole proprietorships or in joint fee ownership. Increasingly, however, nonindustrial forest landowners are turning to partnerships, limited liability companies (LLCs), and corporations as the entities of choice. This particularly is true if two or more persons are involved in the ownership and management. The trend has been accelerated in part due to the increasing financial value associated with managed forest land and the desire to use prudent business and tax practices. In many families, there also is a special interest in using partnerships, LLCs, and corporations for estate planning purposes.

A key factor in selecting a form of organization is whether it is intended that the family forest operation will continue beyond the lives of the current owner(s). If this is not the case, sole proprietorship may be the best vehicle. But if it is expected that the forest as an entity will continue into the next generation, a corporation, LLC, or partnership may be a better choice. Partnerships are discussed in this chapter, corporations in chapter 16, and LLCs in chapter 17.

#### The General Partnership

A general partnership typically is defined as an association of two or more persons, as co-owners, to operate a business for profit. Legal tests for determining what is and is not a partnership have been developed in each State and vary from one State to another. Written partnership agreements are not necessarily required if the actions of the parties involved and the attributes of their relationship are sufficient to indicate partnership status. Most States require a sharing of profits for a partnership to exist; some also require a sharing of losses. Most States give weight to the way the parties believe they are organized; therefore, it may not be wise to use the term “partnership” in business transactions, discussions with others, or correspondence unless partnership status is desired.

The best procedure is to develop a written partnership agreement that clearly states the provisions governing the arrangement. Unless otherwise specified in the agreement, all partners in a general partnership have an equal voice in managing the business and a majority vote governs. Limited partnerships, as discussed below, are an exception to this rule.

#### Partnership Mechanics

Partnership accounting procedures define partnership interests in terms of capital, profits, and losses. A partner’s capital interest is measured by his (her) capital account, which reflects that person’s economic stake in the partnership at any given time. Initial contributions are recorded, and are increased to reflect income and decreased to reflect losses and distributions.

#### Partnership Units

Family partnerships sometimes use partnership units to reflect ownership interests. These are similar to shares of stock and may be represented by paper certificates as is stock. The use of units rather than percentage adjustments on the partnership books makes gifts and sales of partnership interests to family members easier to accomplish. Such transactions can be made simply by transferring certificates.

#### General Partnership Attributes

Under State law, a general partnership is an entity that may acquire and convey title to property. When the partnership does own property, any partner (except in a limited partnership, as discussed below) may convey title on behalf of the partnership.

#### Flexibility

Compared to corporations, general partnerships are extremely flexible. The partnership agreement can be amended to realize favorable economic and tax outcomes up to the time the partnership income tax return is filed. This additional flexibility in structuring financial arrangements, however, may lead to a substantially more complex partnership agreement as well as increased scrutiny under the Federal income tax law.

**Contributions**—Contributions to partnerships need not be equal among partners. Contributions of property to a partnership may be made without recognition of gain; in some cases, this is not possible with a corporation. Generally, assets brought into the partnership or bought with partnership funds become partnership property. The partnership adopts the partner’s basis for property transferred to it, and in turn, the contributing partner’s capital account adopts the basis of the transferred property.

**Withdrawals**—The ability to withdraw property from a partnership without adverse tax consequences is a significant advantage. The distribution of property other than cash by a partnership to its partners normally is not subject to taxation. Instead, the partner receives the property with a carryover adjusted basis, unless the distribution is made in liquidation of a partner's interest. In that case, the adjusted basis of the property is determined with reference to the adjusted basis of the partner's partnership interest. In contrast, corporate distributions are treated as dividend payments or—if made as liquidating distributions—as payments in exchange for stock. Finally, liquidation of a partnership generally is a nontaxable event; this generally is not the case with a corporate liquidation.

### Unlimited Liability

Perhaps the best known characteristic of a general partnership is the unlimited liability of all partners for obligations of the partnership. The partnership creditors must first make a claim against the partnership assets; if any debt remains, they then can make a claim against the personal assets of the individual partners. Also, creditors of an individual partner can make a claim against the partnership assets up to the amount of that partner's interest. These rules do not apply to the limited partners in a limited partnership, as discussed below.

### Management Rights

In a general partnership, all partners have equal rights in the management and conduct of the business. No one can become a member (partner) of the partnership without the consent of all the members. Both of these rules, however, are subject to any agreement to the contrary among the partners. Thus, while State corporate statutes establish specific requirements relating to voting rights within a corporation, partnership statutes permit almost complete flexibility, subject to the requirement that the partners all agree.

### Partners as Agents

Typically, every partner in a general partnership is an agent of the partnership for purposes of its business and any action by a partner within the scope of business will bind the partnership. Partnership liability does not result, however, if the partner has no authority to bind the partnership—for example, if the partner is a minor—and the party with whom the partner is dealing has knowledge of that fact.

### Assignment of Partnership Interest

A partner's assignment of interest in the partnership does not automatically entitle the assignee to participate in the business. Unless the assignee is accepted as a partner by

agreement of all the original partners, the assignee merely is entitled to receive a share of the partnership profits.

### Partnership Taxation

Partnerships are not taxable entities in and of themselves. Although a partnership files an income tax return at the partnership level, it is only an information return. Income or losses are passed through to each individual partner in proportion to his (her) interest in the partnership.

### Partnership Termination

A general partnership may not have as much stability as the members would like. As with a sole proprietorship or joint ownership, a general partnership may be vulnerable to premature liquidation in the absence of prior planning. If there is a written partnership agreement, the term of existence can be stated. Usually, however, partnership agreements provide that the partnership exists at the will of the partners. Even though a term of existence may be specified, the courts generally do not force continuation of the partnership against the desire of a partner to withdraw. Dissolving partners have three choices: (1) liquidate, (2) form a new partnership, or (3) shift to a sole proprietorship or corporation.

On the death of a partner, the surviving partners usually are under a duty to wind up the business and make a distribution to the deceased partner's estate; however, some courts have recognized the right of the surviving partners to bind the deceased partner's heirs to continue the business. When continuation is desired, a provision should be included in the partnership agreement that requires continuation and gives the executor of each partner the power to act as a partner.

## Estate Planning With Partnerships

### Minors as Partners

Estate planning for members of a family partnership often involves transfer of partnership interests to minors. The intention may be to reduce the family income tax bill, reduce death taxes, or simply move older children into the business, but minors as partners can create problems. For Federal income tax purposes, a minor is not recognized as a partner unless control is exercised by another person for the benefit of the minor or the minor is competent to manage his (her) own property and participate in the partnership activities in accordance with his (her) interest in the property. The test of competency is whether the minor has sufficient maturity and experience to be competent in business dealings, regardless of State law.



Unless a minor has significant involvement in the management of the partnership, the interest probably should be conveyed to a trustee, both for the minor's benefit and to conform to Internal Revenue Service (IRS) regulations that require adequate judicial supervision. A minor may, however, be a limited partner because—as discussed below—limited partners are precluded from management. In any event, a gift of a partnership interest should be made only in accordance with the Uniform Gift to Minors Act as discussed in chapter 8.

### Retained Control

Whether the donor of a partnership interest should retain control of the partnership usually is a nontax matter involving basic personal goals. Retention of control, however, may involve significant income and estate tax consequences. The owner of a capital interest in a partnership structured around family forest land will be recognized as a partner for income tax purposes, whether the owner received the interest by purchase or by gift. Retained control over a gifted interest may cause the donor to be treated as the owner for income tax purposes. Whether the retained controls are significant enough to cause such a result is a question of fact. This problem can be circumvented with a limited partnership.

### Spousal Partnerships

The situation of spouses who jointly own and manage forest land can be confusing as to whether or not a partnership actually exists. If the joint activity constitutes and is treated as a business, there is a presumption that the activity is a partnership. Under a provision of the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28), however, spouses who conduct a qualified joint venture and who file a joint Federal income tax return can elect to be treated as two sole proprietorships rather than a partnership for tax purposes. A qualified joint venture is any joint activity involving the conduct of a trade or business, if: (1) the husband and wife are the only members of the joint venture; (2) each qualifies independently as a material participant in the trade or business according to the passive loss rules, without regard to the rule that treats participation by one spouse as participation by the other; and (3) both elect for the provision to apply. If the spouses make this election, all items of income, gain, loss, deduction, and credit are divided between them according to their respective interests in the venture, each files his (her) own business and self-employment tax forms, and each receives credit for paying Social Security and Medicare taxes.

### Limited Partnerships

Limited partnerships are closer in structure to corporations than are general partnerships. In most States, a partnership may be organized with one or more limited partners if there is at least one general partner. Limited partners do not have personal liability beyond their investments in the partnership. The price of this status is that limited partners may not participate in management; only general partners have management authority.

A limited partner who does participate in management may become liable as a general partner. Nevertheless, the limited partnership provides an ideal vehicle for excluding family members such as minors and distant co-owners from management control. A limited partnership also may be useful if one of the partners, such as a parent, wishes to withdraw from active participation in management of the family forest land. It permits the parent to leave capital invested in the partnership without the fear of unlimited liability.

Unlike a general partnership, which requires no formal action other than agreement among the partners, a limited partnership must be formed in compliance with specific State law. This requires the execution of a certificate of limited partnership which is placed on file with a public official, usually the county clerk.

### Family Limited Partnerships

A family limited partnership (FLP) typically is created for estate planning purposes by transferring family assets likely to appreciate rapidly to a new limited partnership created under the law of the applicable State. In exchange for the assets, the transferor generally receives a very small general partnership interest (typically 1 to 2 percent) and a large limited partnership interest. The transferor retains the general partnership interest and over a period of time transfers limited partnership interests to family members—usually children. The interests received typically are minority interests. The general partnership interest gives the transferor control over operation of the business even though that interest represents only a small percentage of the value of the business.

**Tax advantages**—Limited partnership interests transferred to children under an FLP are worth significantly less for gift tax purposes than the value of the same proportional interest in the underlying assets. The holder of a minority limited partnership interest cannot make decisions about how the business is run, demand distributions, or force a liquidation of the partnership. In addition, an interest in an FLP may be far less marketable than an interest in the underlying assets of the business. Accordingly, as discussed



in chapter 4, minority interest and lack of marketability discounts generally are allowed on the transfer of interest in an FLP. The combined discount for a minority interest and lack of marketability typically is in the 20 to 40 percent range, but can be even higher.

**Nontax advantages**—A family limited partnership also provides certain nontax advantages which include: (1) the ability to retain control over transferred assets; (2) ease of probate; (3) ease of amendment of the partnership operating structure; (4) protection from creditors; and (5) facilitation of use of the gift tax annual exclusion.

### **IRS Attacks on Family Limited Partnerships**

**The sham transaction doctrine**—In IRS Technical Advice Memorandum 9719006 (January 14, 1997), the IRS launched a major attack on FLPs. Under the facts of this ruling, assets were transferred from two trusts to an FLP that was created two days before the decedent's death. Immediately after the FLP received the assets, limited partnership interests were transferred to the transferor's children. The IRS ruled that valuation discounts, claimed with respect to the FLP transaction, should be disallowed under either of two theories. One theory was that, consistent with the sham transaction doctrine, the formation of the partnership interest should be treated as a single testamentary transaction; therefore, the partnership should be disregarded for estate tax valuation purposes.

The alternative theory of the IRS was to apply Internal Revenue Code (IRC) section 2703 to the transaction, with the result that, for transfer tax purposes, the value of the property is determined without regard to any option, agreement, or other restriction on the right to sell or use the property. The purpose of section 2703 is to prevent possible distortions in value that might result if a transferor retained certain rights or imposed certain restrictions with respect to the transferred property without intending to exercise the

rights or restrictions. The estate argued that the property transferred was the partnership interests and—because there were no restrictions in the partnership agreement relating to the transferees' ability to sell, transfer, or use the interests—section 2703 did not apply. The IRS disagreed, taking the position that what the children really received was the underlying assets subject to the partnership agreement. Thus, the partnership agreement was a restriction within the meaning of section 2703, and any reduction in value caused by the partnership agreement was to be disregarded under section 2703 unless the bona fide business arrangement exception of section 2703(b) was applicable.

The IRS concluded that even if the steps of the transaction were not collapsed and the partnership interests, rather than the underlying assets, were treated as the subject of the transfers, section 2703 still would apply. This is because under Treasury Regulation 25.2703-1(a)(3), a section 2703 restriction either can be contained in a partnership agreement or implicit in the capital structure of the partnership.

### **Applicable restrictions under IRC section**

**2704**—Citing the underlying Code and Regulations, the IRS has published several Technical Advice Memoranda denying FLP valuation discounts that were deemed to relate to "applicable restrictions." With respect to an FLP, an applicable restriction is one that effectively limits the transferor or any donee of a partnership interest from removing a restriction preventing liquidation of the partnership. Treasury Regulation 25.2704-2(b) provides that a limitation on the ability to liquidate the partnership that is more restrictive than the limitations that would apply under State law in the absence of the restriction will be deemed an applicable restriction for purposes of IRC section 2704. If an applicable restriction is disregarded, the transferred interest is valued as if the restriction did not exist and as if the rights of the transferor were determined under the State law that otherwise would apply.

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## Chapter 16

### Corporations

Closely held family forest corporations exist in substantial numbers in most States with large commercial timber acreage. Fewer have been formed in recent years, however, with the move to limited liability companies and family limited partnerships. In the past, estate planning considerations were a major reason for incorporation of nonindustrial forest land. The corporate stock typically is owned by persons related by blood or marriage or both. Some nonindustrial forest land corporations also are owned by unrelated shareholders; most of these are small and closely held.

#### Corporate Formation and Management

A corporation is a distinct legal entity, separate from the shareholders who own it or from those who manage or work for it. A corporation has most of the rights of an individual: it can sue and be sued, enter into contracts, and own property, all in its own name.

A corporation is formed by drafting the necessary documents and filing them with the designated State official, usually the Secretary of State. Generally, these documents consist of the corporate name, the nature of the business, the names and addresses of the incorporating parties, the corporate charter, and the articles of incorporation. State law specifies certain items to be addressed in the charter and articles of incorporation. Additional documents may be required as well, depending on the State in question. An incorporation fee will have to be paid and reports filed at least annually with the State.

#### Qualifying as a Foreign Corporation

Because a corporation is formed under the laws of a particular State, it cannot do business in other States without qualifying in them as a foreign corporation. This requirement should be considered if the forest ownership in question lies in more than one State; however, occasional transactions outside the State of incorporation that do not occur on a regular basis generally do not constitute “doing business.”

#### Limited Liability

Perhaps the most notable feature of a corporation is the limited liability status of its shareholders. Corporate debts

and liabilities may be satisfied only from corporate assets. Thus, unlike general partnerships, shareholder personal assets—other than their investment in the corporate stock—are protected from corporate liability. If the shareholders commit substantial personal assets to the corporation, limited liability obviously has less meaning than if such assets are maintained outside the corporate structure.

**Loss of limited liability**—A corporate shareholder may lose his (her) limited liability in any of three ways: (1) if the shareholder is personally involved in a tort that gives rise to corporate liability; (2) if the shareholder personally signs a corporate contractual obligation—that is, signs without acting on behalf of the corporation; or (3) if the corporation fails to meet and maintain corporate organization and management requirements on a continuing basis.

#### Corporate Management

A corporation contains three clearly defined managerial groups: shareholders, board of directors, and officers. In a closely held family corporation, the same individuals often fill all these positions.

**Shareholders**—The shareholders are the persons who have contributed money or property to the corporation in return for shares of stock. In some cases, the stock may have been received by gift or inheritance. The shareholders are the basic decision-making group. They approve changes in the corporate charter and articles of incorporation, and also elect the board of directors. Each shareholder has one vote for each share of voting stock. Most States permit nonvoting stock but a few do not.

Generally, a majority vote governs, and the holders of 51 percent or more of the voting stock have direct control over corporate decisions made at the shareholder level. The shareholders also indirectly control decision-making at the other levels because of their power to elect the board of directors. Minority shareholders have little, if any, decision-making power unless permitted by the majority.

It is possible to grant minority shareholders greater participation in decision making. In most States, the vote level required for shareholder action may be increased from a simple majority to some higher level. The majority of States also allow cumulative voting. This procedure allows shareholders to multiply their votes by the number

of directors to be elected and cast the entire number for one director; it helps ensure that minority shareholders will be represented on the board of directors.

**Board of directors**—The board of directors is the policy-making body of the corporation. It develops corporate policy and long-range management strategies. The board also establishes the bylaws, which are written rules and guidelines for corporate structure and day-to-day management. The directors may receive fees for their services but are not salaried. In a family corporation, the fees may be waived. The selection of the officers is another important responsibility of the board.

**Officers**—The officers are the day-to-day corporate decisionmakers. Usually in a small or family corporation these are a president, vice president, secretary, and treasurer. The officers often also function as employees and receive salaries. They are charged with executing policy developed by the board of directors. Authority to hire employees, sign negotiable instruments, enter into contracts, and borrow money may be granted to designated officers by the board.

## Income Tax Implications of Incorporation

Before addressing estate planning considerations related to corporations, a discussion of income tax implications is appropriate. An incorporated family forest is treated virtually the same with respect to expenditures as is a noncorporate forest ownership. Certain other aspects of corporate income taxation, however, differ from the rules applicable to individual forest landowners.

### Depreciation

Although depreciation is handled in essentially the same way after incorporation as before, there are a few exceptions. One of these concerns the expense method of depreciation under section 179 of the Internal Revenue Code (IRC). Section 179 permits most taxpayers in a trade or business to immediately deduct, rather than depreciate over a period of years, up to \$128,000 of otherwise depreciable costs per tax year [2008, as set by the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)]. The maximum deduction phases out dollar-for-dollar for that portion of the total cost of qualifying property placed in service during the year that exceeds \$500,000. For example, if \$547,000 of qualifying property were placed in service during the year, the maximum deduction under section 179 would be \$81,000 [ $\$128,000 - (\$547,000 - \$500,000)$ ]. With respect to corporations, members of a group of controlled corporations (discussed below) divide the expensed amount. Normally, however, a family forest corporation will not be

part of a group of controlled corporations. In that case, there is no difference in section 179 treatment between corporate and noncorporate taxpayers.

## Taxation of Corporate Income

Two methods for the taxation of corporate income are available to qualifying corporations. These are the regular method for so-called “C” corporations and the tax-option method for so-called “Subchapter S” corporations. Most closely held family corporations will qualify for either method.

### “C” Corporation

If no Subchapter S election is made as discussed below, a family forest land corporation will pay income tax under the regular method. The current corporate marginal tax rates are as follows:

Corporate taxable income over	But not over	Marginal tax rate
\$0	\$50,000	15 percent
\$50,000	\$75,000	25 percent
\$75,000	\$100,000	34 percent
\$100,000	\$335,000	39 percent
\$335,000	\$10,000,000	34 percent
\$10,000,000	\$15,000,000	35 percent
\$15,000,000	\$18,333,333	38 percent
\$18,333,333	—	35 percent

The chart reflects a 5-percent surtax, to a maximum of \$11,750 in additional tax, imposed on corporate taxable income above \$100,000 and a 3-percent surtax on taxable income above \$15 million, to a maximum of \$100,000 in additional tax. The 5-percent surtax entirely eliminates the benefits of the 15- and 25-percent brackets for corporations with taxable income over \$335,000, and partially eliminates the benefits of the 15- and 25-percent tax brackets for corporations with taxable income between \$100,000 and \$335,000. The 3-percent surtax recaptures the benefit of the 34-percent tax bracket for corporations with taxable income over \$15 million.

The attractiveness of the regularly taxed corporation depends on the relationship of corporate income tax rates to the rates applicable to individuals. For individuals, the top marginal tax rate for ordinary income currently is 35 percent, compared to 39 percent (including surtax) for corporations, as shown above. While this may be considered a small difference, the spread between corporate and noncorporate long-term capital gain rates is considerably greater. For individuals, capital gains are taxed according to a different rate schedule from ordinary income, with a maximum tax rate of 15 percent for most long-term capital gains. However,

for corporations, capital gains are taxed according to the same rate schedule as ordinary income, with a minimum rate of 15 percent and a maximum rate of 39 percent (including surtax). This is particularly significant in the case of corporate family forest lands where, presumably, most of the income would be from timber sales and thus a capital gain.

In effect, formation of a regularly taxed corporation represents creation of a new taxpayer at the 15-percent rate for the first \$50,000 of corporate taxable income and at the 25-percent rate for the next \$25,000. This may represent a tax saving for shareholders whose individual rates are higher than 25 percent with respect to ordinary income left in the corporation for business purposes or expansion. If, however, the net earnings are then removed from the corporation and paid to the shareholders as dividends, the shareholders will have to pay an additional tax on the dividends, resulting in the so-called “double taxation” associated with “C” corporations.

A group of controlled corporations cannot be used to circumvent the graduated corporate rate brackets. In other words, it is not possible to create two or more corporations with common ownership in order to take advantage of the reduced corporate tax rates on the first \$75,000 of corporate taxable income. Thus, if two corporations are established with respect to a family forest land—one to own the land and the other the timber—there will be only one set of graduated rate brackets below 35 percent. With no stipulation for unequal apportionment, each corporation would be taxed at 15 percent on the first \$25,000 of taxable income and at 25 percent on the next \$12,500.

### Subchapter S Corporations

Although the double taxation of dividends associated with family-owned “C” corporations can sometimes be avoided to a certain extent by making payments in the form of salaries and bonuses which are deductible by the corporation, this method will never alleviate the problem entirely. Another problem concerns the corporation accumulating funds rather than using them to pay dividends. The so-called “accumulated earnings tax” is designed to discourage the buildup of funds within a corporation in excess of reasonable business needs. A corporation can accumulate up to \$250,000 of earnings and profits without imposition of the tax. Beyond that level, accumulations are taxed at a 15-percent rate unless higher accumulations are justified as retained for the reasonable needs of the business. For those family forest land corporations investing in additional forest holdings, the \$250,000 level should pose no problem—particularly in light of the fact that amounts in excess of that level can be justified for business purposes.

**Method of taxation**—The Subchapter S corporation method of taxation was enacted in 1958 to remove the disadvantages of the regular corporate method of income taxation, as outlined above, for small, family-owned corporations. If a corporation that meets the requirements (discussed below) elects Subchapter S status by filing Form 2553, *Election by a Small Business Corporation*, with the Internal Revenue Service (IRS), double taxation is eliminated. There is no taxation of earnings at the corporate level. Only the dividends paid to shareholders are taxed—on their individual returns at their individual rates. For all other purposes, however, a Subchapter S corporation remains identical to a “C” corporation.

**Distributions**—A Subchapter S corporation passes through to its shareholders their pro rata share of capital gains and losses, ordinary income or losses, business deductions, depletion allowances, tax exempt interest, and credits, on a daily basis. The shareholders then report these items on their individual income tax returns. Gains and earnings are taxed to the shareholders as if actually received, even if held by the corporation for expansion or to be paid out as dividends at a later time. Generally, distributions from a Subchapter S corporation without earnings and profits are tax-free to the extent of a shareholder’s adjusted income tax basis in the stock (the amount of original investment in the stock not previously recovered). If a distribution exceeds a shareholder’s adjusted basis, the excess is treated as a capital gain.

**Effect on basis**—Distributions from a Subchapter S corporation thus can affect the income tax basis of the corporate stock. Undistributed taxable income on which tax is paid by the shareholders increases the basis of their stock, while losses and tax-free distributions of previously taxed income reduce the basis. To avoid later confusion over stock basis, the basis for each shareholder should be computed annually and made a matter of record.

### Requirements for Electing and Maintaining Subchapter S Status

A number of requirements must be met in order for a corporation to elect Subchapter S status with the IRS and continue to maintain that status.

There can be no more than 100 shareholders, although multiple members of a family may elect to be treated as one shareholder. A family member is defined as a common ancestor, the lineal descendant of the common ancestor, and the spouses (or former spouses) of the ancestor and the descendants. A surviving spouse and the estate of a deceased spouse also are treated as one shareholder. Generally, all shareholders must be individuals or the estates of individuals. In certain limited circumstances, however, trusts



can be shareholders. Nonresident alien shareholders are not permitted.

**Stock**—A Subchapter S corporation can have only one class of stock outstanding. Differences in voting rights are allowed, however, and do not violate the requirement for a single class of stock. This can be an important consideration when minor children are shareholders. Preferred stock is not allowed.

**Accumulated earnings carryover**—Some “C” corporations have accumulated earnings and profits when the Subchapter S election is made, which are carried over to the Subchapter S corporation. A Subchapter S corporation in this position cannot have passive investment income, such as interest, in excess of 25 percent of gross corporate receipts for more than two consecutive years. If this occurs, its Subchapter S status will be terminated. This rule could constitute a trap for the unwary Subchapter S forest land that maintains an interest-bearing bank account in years in which no timber harvesting is done.

**Election**—The election, as noted above, is made by filing IRS Form 2553, Election by a Small Business Corporation. It may be made at any time during the preceding taxable year, or, on or before the 15th day of the third month of the taxable year in question. An election made too late for one year becomes effective for the following year. All shareholders of record must consent to the election. The election can be voluntarily revoked, but only if the holders of more than 50 percent of the outstanding shares of stock (voting and nonvoting) consent to the revocation. Thus, a new shareholder by reason of gift or inheritance cannot unilaterally terminate the election, as once was allowed, unless he (she) owns a majority of the stock. The election also can be terminated by the IRS for failure to continue to meet the Subchapter S requirements.

In general, a new election cannot be made within 5 years of a revoked election without IRS consent. This provision was recently utilized by a Subchapter S corporation formed to hold and manage forest properties (Private Letter Ruling 9111036, December 17, 1991). In 1986, the corporation obtained a new treasurer who was unaware of the Subchapter S election and thus began filing conventional “C” corporation tax returns. In addition, the corporation—through the treasurer—violated the 25-percent passive income rule because no timber sales were made for a number of years due to depressed prices, but interest was earned on the accumulated earnings realized from the “C” corporation years. For these reasons, the IRS revoked the Subchapter S status in 1990. At the corporation’s request, however, the IRS determined that the election had been terminated inadvertently because of the treasurer’s lack of knowledge. It permitted the corporation to return to Subchapter S status in 1991 after filing amended tax returns

for the tax years after 1987, paying additional taxes due, and eliminating the interest-bearing account until timber sales were resumed.

## Estate Planning Considerations

Certain characteristics of corporate ownership may enable a more complete accomplishment of a forest owner’s estate planning objectives, depending on personal goals and the particular facts of the situation, than might other forms of ownership. This particularly is true if the forest land is to continue as an economic unit beyond the death of the parents as majority or sole owners.

### Lifetime Transfer of Stock

When planning for continuation of the family forest enterprise, particular attention should be given to transfers of ownership and management from one generation to the next. This process is simplified with a corporation, in which ownership and control is facilitated merely by transferring shares of stock.

Parents who are sole owners or co-owners of a forest property may be reluctant, for reasons of personal security, to make gifts of the property to their children in order to achieve estate tax savings or business continuation. Their fear may be compounded by the fact that the donees are free to retransfer the property to others once the gifts are made. Restrictions on retransfers often are unenforceable. Even if gifts are acceptable, donations of forest land are not easily made—either in terms of undivided interests or as separate parcels (see chapter 8).

In contrast, transfer of corporate stock does not involve these disadvantages. Forest land ownership can be divided into easily transferred shares of stock so that their gift or sale translates into a proportionate share of the forest. Majority owners can dispose of some stock without losing control over decision making. They can be assured of continued employment as corporate officers and of control over corporate dividend policy, which eases the income security problem. They also can place restrictions on the retransfer of stock by those receiving it through gift or sale. Additionally, they can use stock to channel forest land income to low tax bracket taxpayers so as to minimize overall income tax liability.

### Transfers to Minors

It may be desirable to transfer interests in the forest land to minors in order to reduce the family income tax burden or to encourage the minors to develop a greater involvement and interest in the forest operation. Minors, however, generally

are not considered legally competent to manage their property. The transfers of property interests to minors have long created problems. Such gifts usually are made easier if the transfer is in the form of shares of corporate stock.

**Uniform gifts to minors acts**—Stock in a family corporation is eligible for transfer to minors under the Uniform Gifts to Minors Acts now available in every State. These statutes are relatively easy to use, inexpensive, and involve little red tape. Basically, they provide for a simple custodianship by which a bank or an adult holds and manages the property for the minor. Only gifts of stock, securities, or money are eligible for transfer in most States; gifts of land and timber generally are not eligible. An important consideration is that, if the donor also is the custodian and dies before the child reaches majority, the amount of the property held would very likely be included in the donor's estate for death tax purposes. Therefore, the custodian probably should be someone other than the donor.

**Unearned income**—Unearned (investment) income of a dependent child under age 19 at the close of the tax year—or under age 24 if the child is a full-time student and has at least one living parent—generally will be taxed at the parent's top marginal income tax rate if the child's investment income exceeds the sum of the standard deduction for dependents (\$900 in 2008) and the greater of \$900 or the itemized deductions directly connected to the production of that investment income. This rule may lessen the advantage of making transfers to children.

There are two exceptions to the general rule. The first is if the child files a joint return with his (her) spouse for the tax year; the second is for funds distributed from a qualified disability trust as defined under IRC section 642. These distributions are treated as earned income.

## Estate Settlement

A corporation is an entity that does not terminate when one of the owners (a shareholder) dies. On the other hand, at the death of an individual owner with fee title, all of his (her) property normally is subject to probate—a process during which all assets usually are administered by the estate representative. Upon the death of a corporate shareholder, only the corporate stock owned by the decedent is subject to probate and transfer, not the underlying assets. The stock, of course, must be valued for Federal estate and State death tax purposes, but the forest enterprise may be continued without interruption.

**Ancillary probate**—If an individual owns real property in two or more States, a probate proceeding normally is required in each State. A probate court proceeding in one State cannot pass title to real property, including land

and timber, in another State. Thus, the original probate proceeding is held in the State of residence and ancillary probate in the other State(s). In the event that a corporation owns real property in two or more States, however, ancillary probate proceedings are not required because corporate stock is personal property—not real property—and generally is subject to the law of the decedent's State of domicile at death.

## Loss of Capital

The right of partition and sale (see chapter 14), which generally is available to joint tenants or tenants in common for terminating co-ownership arrangements, is not available to corporate shareholders. While shareholders who are not active participants in the operation of a corporate forest enterprise may have sufficient votes to dissolve the corporation, they do not have the option of receiving their portions through division or forced sale of the property. This particular corporate feature may cause disputes. Restrictions often are placed on retransfer of inherited or gifted stock, and minority shareholders have relatively few management rights.

**Stock purchase options**—To avoid this problem, it may be advisable for those most concerned with continuity of the forest enterprise to gradually purchase the stock held by the other shareholders. A buy-sell or first option agreement could specify that the purchase price is to be paid either in cash or by installments over a period of time with interest.

As an alternative, stock could be permitted to pass to minority heirs with specific rights granted in regard to management, a minimum dividend level in conjunction with timber sales, and a ready market for their stock in the event they wish to sell. This would balance corporate stability against minority shareholder rights.

## Corporate Disadvantages

A corporation has estate planning disadvantages as well as advantages. Some can be resolved with proper planning, while others cannot.

**Subchapter S corporations**—As discussed above, a Subchapter S corporation can have no more than 100 shareholders. If death and inheritance increase the number of shareholders to more than 100, Subchapter S status is lost. Another disadvantage is that a Subchapter S corporation's stock cannot be held by a trust except in certain limited instances, even though trusts are a key estate planning device (see chapter 9). It is not possible to establish a testamentary trust for minors, with the trust holding Subchapter S stock, and have the trust continue as a shareholder for more than a short period of time after the death of the grantor. Nor is it



permitted for stock in a Subchapter S corporation to be held by a marital deduction trust (see chapter 9).

**Complexities and expenses**—Incorporation is a more formal and complex method of organization than a sole proprietorship or partnership, and a corporation is more expensive to establish and maintain. In addition to the legal cost of incorporation, most States impose an annual fee and require the filing of an annual report. The initial costs are deductible over the first 5 years, however, and subsequent costs usually are deductible annually.

**Liquidation**—A corporation generally can be dissolved under State law either by written consent of all shareholders or by approval of the board of directors followed by a simple majority or higher vote of the shareholders. This process usually poses few problems. The greatest concern is the income tax consequences of liquidation as the corporate assets are distributed to the shareholders in exchange for their stock. A corporation can be formed rather easily without paying income tax on the gain in property transferred to the corporation, but it can be difficult to liquidate a corporation without adverse income tax consequences. Basically, a liquidating corporation, including a closely held family corporation, recognizes gain or loss on the distribution of property that takes place in a complete liquidation as if the property had been sold at its fair market value.

**Death of a shareholder**—Upon the death of a shareholder, the shares of stock owned by the decedent will (under current law) receive a “stepped-up” basis to market value as of the date of death (or alternate valuation date if elected). The underlying assets—such as forest land owned by the corporation—are a determinant in the value of the stock, but do not themselves receive a stepped-up basis.

### **Revised Estate Plans**

When a corporation is formed, the wills and estate plans of each shareholder should be reviewed. Corporate stock is personal property and will pass as such at the death of the shareholder. If a will was drafted to pass real property, it may have become outdated by incorporation. If Subchapter S status has been elected, wills should be checked and revised, if necessary, to ensure that the stock does not pass into a testamentary trust. If it does, the Subchapter S election will be lost after 2 years and the corporation will revert to “C” corporation status.

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## Chapter 17

### Limited Liability Companies

A limited liability company (LLC) is a hybrid entity that combines the corporate benefit of limited liability for its owners with the partnership's advantage of pass-through treatment for income tax purposes. It is created under State law, just like a corporation. All 50 States have enacted LLC statutes; however, legislative and administrative details vary from one State to another.

#### Organization and Operation

##### Articles of Organization

Instead of filing articles of incorporation, an LLC files articles of organization with the designated State authority—usually the Secretary of State. The articles notify potential creditors that, generally, the LLC itself will be the sole recourse for payment. Companies that fail to properly file articles of organization may be fined, barred from doing business in the State, or have difficulty establishing legal status to sue. Further, creditors may try to reach the personal assets of LLC members as though they were partners in a general partnership.

##### Members

An LLC is owned by its members, rather than by shareholders or partners as with a corporation or partnership. Most LLCs have at least two members. This is consistent with classification of an LLC as a partnership for income tax purposes. Many States, however, permit one-member LLCs; a one-member LLC can be taxed either as a corporation or a sole proprietorship. The partnership classification rules of the Internal Revenue Code (IRC) do not condition partnership status on the legal form of an entity's owners; thus, an individual, corporation, partnership, trust, estate, another LLC, or other legal entity may be a member of an LLC.

Contributions to an LLC, in exchange for a membership interest, may be made in the form of cash, property, use of property, services, or any other valuable consideration. In some States, contributions also may be made in the form of promissory notes or other binding obligations.

##### Operation

Generally, an LLC is not required to have an operating agreement. Some States, however, require the adoption of an agreement and specify certain mandatory provisions. In the absence of an operating agreement, an LLC is governed by its articles and State law. Provisions concerning the business of the LLC usually may be included in an operating agreement to the extent that they are not inconsistent with State law or the articles of organization.

##### Management

The typical State LLC statute makes extensive use of default rules, which are statutory provisions that apply unless the articles of organization or operating agreement specify otherwise. Default rules, however, allow an LLC to go beyond the statute to customize administration and management to suit the needs of its members. The statute generally reserves management rights for the members in proportion to their capital contributions or income interest, unless the articles provide differently.

**Ownership interests**—State law usually permits members of an LLC to customize both distribution of cash and property and allocation of profits and losses to themselves through the operating agreement or articles. In the absence of such special financial provisions, distributions generally are made and profits and losses allocated on a proportional basis in accordance with the members' respective contributions.

**Withdrawals**—State law also generally permits members of an LLC to withdraw on 6-month's notice and receive the fair market value of their interests, unless otherwise provided in the articles or operating agreement. Withdrawals, deaths, bankruptcies, and other events that cause the loss of a member can have serious consequences because the LLC could terminate unless the remaining members agree to continue the business. An LLC also can be dissolved by written consent of its members or by court order if it is unable to carry on the business.

**Assignment of interest**—Unless the operating agreement or articles provide otherwise, a membership interest is assignable to another in whole or in part. The assignment entitles the assignee to receive, to the extent assigned, the distributions to which the assignor otherwise

would have been entitled. In most States, in order for an assignee to participate in management of an LLC or to exercise other membership rights, the remaining members must unanimously agree to the assignee's admission as a member. Some State statutes may permit an agreement over and above the operating agreement that allows an assignee to become a member on the consent of fewer than all the remaining members.

**Limited liability**—One of the key advantages of an LLC is that it provides limited liability to all of its members and managers. This is the primary distinction between an LLC and a limited partnership. In the latter, general (managing) partners usually have unlimited liability with respect to partnership debts. On the other hand, the typical State LLC statute provides that an individual or entity belonging to an LLC does not have any personal obligation for the LLC's obligations solely because of being a member, manager, or other agent of the LLC. Thus, all LLC members are shielded from personal liability, regardless of the extent of their management activities. Some States permit a member to waive limited liability.

## Tax Considerations

In addition to protecting the members' personal assets from liability for the debts and obligations of the business, as discussed above, a primary reason for using the limited liability company form of organization is tax related. The LLC form of organization avoids the double taxation associated with a corporation but achieves pass-through taxation for the members. Thus, from an income tax perspective, an LLC compares favorably with both S corporations and partnerships, and at the same time has advantages not available with the other two types of entities. For example, an LLC member can materially participate in the business activities of the LLC—so that income and losses that are passed through to him (her) are considered active under the passive loss rules—without risking personal liability. In contrast, a limited partner who materially participates in the partnership business within the meaning of the passive loss rules may risk liability for the partnership's obligations. The key to the favorable tax status of LLCs is that they are unincorporated business entities; the Internal Revenue Service (IRS) will not treat unincorporated entities as corporations unless they elect not to be taxed as partnerships.

## Basis and Distribution of Property

The method of determining basis differs for LLCs and S corporations. In an LLC, a member's basis includes a share of all LLC liabilities, while in an S corporation not all of the corporate liabilities qualify as part of shareholder basis. This restriction can limit an S corporation shareholder's ability to

use pass-through losses to offset other income and receive tax-free distributions in a refinancing.

Neither an LLC nor a member recognizes any gain or loss if the LLC distributes appreciated property to the member. An S corporation, on the other hand, recognizes gain to the extent that the fair market value of the property distributed exceeds the corporation's basis in the property.

## Implications for Timber Properties

The LLC represents the latest advance in forms of business entities. An LLC that is classed as a partnership and assured of limited liability in all jurisdictions in which it operates combines ownership, operational, tax, and liability advantages in a way that neither the Subchapter S corporation nor the limited partnership can do. For a family-owned forest enterprise, the LLC certainly has advantages as a way to organize for current operations.

## Estate Planning

The LLC also shows promise as an estate planning tool. Because the LLC format is relatively new, however, its use in estate planning still involves some uncertainties, particularly with respect to valuation adjustments as discussed in chapter 4. The *Hackl* case, below, illustrates potential problems.

**Hackl case**—In *Hackl, C.M. v. Commissioner*, [118 TC 279, affirmed 335 F.3d 664 (CA-7), 2003-2 USTC ¶60,465], the transfer of LLC timberland interests to the donor's children was held to be gifts of future interests that failed to qualify for the annual gift tax exclusion (see chapter 8). Under terms of the LLC operating agreement, the donor as "Chief Manager" had the personal right to name a successor as well as absolute discretion to permit or deny withdrawal of capital contributions by a member, make or withhold cash flow distributions, and permit or deny the transfer or encumbrance of membership interests. The LLC had failed to make distributions to members for several years or to adopt a forest management plan to seek long-term appreciation and income. It should be noted that it was not at issue whether the donations would have qualified under the \$1 million lifetime Federal gift tax exclusion (see chapter 8) wherein gifts of future interests are allowable.

**Planning options**—Several planning options exist that arguably may circumvent the *Hackl* result. These include granting recipients of LLC interests a withdrawal right similar to a "Crummey" power (see chapter 9), permitting sales of the LLC interests subject to rights of first refusal, granting donees a limited period to sell interests to anyone, making gifts of cash which are then used by the donees to purchase the interests, and providing for mandatory distributions at prescribed earnings levels.

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## Chapter 18

### State Transfer Taxes

#### Types of State Transfer Taxes

Tax planning for forest management generally focuses on income and property taxes. As discussed throughout this book, the effect of the Federal estate tax often is overlooked. This is an oversight that can cause serious disruptions in the orderly transfer of forest land at death. In the same way, State transfer taxes also must be considered in estate planning, due to their actual cost and to the possibility that they will upset strategies that address only Federal taxes.

States levy four different types of taxes on the transfer of property: gift taxes, estate taxes, generation-skipping transfer taxes, and inheritance taxes. As with their Federal counterparts, State gift taxes are levied on an individual's lifetime transfers of property over and above annual and/or lifetime exclusion amounts; State estate taxes are levied on the right of a decedent's estate to transfer property; and generation-skipping transfer taxes are levied on the right of individuals to transfer property to persons two or more generations younger than themselves, either through an outright gift or a transfer in trust. An inheritance tax is levied on the right of an individual heir or legatee to receive property from a decedent's estate.

At the time the last edition of this book<sup>1</sup> was published, all 50 States taxed the transfer of forest land and other assets at death, either through an estate tax or an inheritance tax. Of that total, 13 States had both estate and inheritance taxes, and 2 States had two different estate taxes in effect. In addition, 6 States taxed large gifts and 27 States taxed generation-skipping transfers.

#### Effect of the Economic Growth and Tax Relief Reconciliation Act

Before enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; Public Law 107-16), every State had a transfer tax system under which at least one tax was set equal to the maximum Federal credit for State transfer taxes allowed under Internal Revenue Code (IRC) section 2011 or 2604. This approach did not result

in any additional tax burden on estates or individuals, but apportioned a part of what would have been the Federal tax bill to the State.

Most States simply set their transfer tax(es) equal to the maximum allowable Federal credit. This approach is called a "pick-up" or "sponge" tax. States with separate stand-alone transfer taxes used a second "piggy-back" transfer tax to make up the difference between their stand-alone tax(es) and the maximum Federal credit.

EGTRRA, however, phased out the Federal credit for State transfer taxes between 2002 and 2005, and from 2005 on, replaced it with a deduction. This change in how the Federal estate tax is calculated threatened to eliminate all State transfer taxes that were tied to the Federal credit, throwing State tax law and tax planning into turmoil.

The individual States have responded very differently to the changes brought by EGTRRA. Some have made no change to their transfer tax systems, allowing estate, inheritance, gift, and generation-skipping transfer taxes tied to the Federal credit to phase out. Others have seen EGTRRA as an opportunity to repeal transfer taxes, while still others have seen it as an occasion to craft new levies on transfers of property.

#### Current State Transfer Taxes

**Estate and inheritance taxes tied to the Federal credit**—Tables 18.1 through 18.4 summarize the current (2008) transfer tax laws of States in, respectively, the Northeast, North Central region, South, and West. Each table has separate columns for each type of transfer tax: estate, inheritance, gift, and generation-skipping. States that have a given type of tax are indicated with an X in that column; an accompanying footnote outlines the provisions of the tax and notes if it has been allowed to phase out with the Federal credit. The few States with two taxes of the same type are indicated with two Xs, with the provisions of both outlined in a single footnote. States that do not have a type of tax are indicated with a dash in the column, while States that recently have repealed a tax—or replaced it with a different type of tax—are indicated with a footnote that gives the date of the change.

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<sup>1</sup> Haney, H.L., Jr.; Siegel, W.C. 1993. Estate planning for forest landowners: what will become of your timberland? Gen. Tech. Rep. SO-97. New Orleans, LA.: U.S. Department of Agriculture Forest Service, Southern Forest Experiment Station. 186 p.

**Table 18.1—State transfer tax systems in the Northeast, 2008**

State	Estate	Inheritance	Gift	Generation-skipping
Connecticut	X <sup>a</sup>	X <sup>a,b</sup>	<sup>m</sup>	—
Delaware	X <sup>c</sup>	—	<sup>n</sup>	—
Maine	X <sup>d</sup>	—	—	—
Maryland	X <sup>e</sup>	X <sup>e</sup>	—	X <sup>p</sup>
Massachusetts	X <sup>f</sup>	—	—	X <sup>p</sup>
New Hampshire	X <sup>c</sup>	<sup>l</sup>	—	—
New Jersey	X <sup>g</sup>	X <sup>g</sup>	—	—
New York	X <sup>h</sup>	—	<sup>o</sup>	X <sup>p</sup>
Pennsylvania	X <sup>i</sup>	X <sup>i</sup>	—	—
Rhode Island	X <sup>j</sup>	—	—	X <sup>p</sup>
Vermont	X <sup>k</sup>	—	—	X <sup>q</sup>
West Virginia	X <sup>c</sup>	—	—	—

Sources: CCH Financial Planning Toolkit. <http://www.finance.cch.com/text/c50s15d170.asp>. [Date accessed: September 11, 2008]. Bankrate.com State Tax Roundup. [http://www.bankrate.com/brm/news/news\\_taxes\\_home.asp](http://www.bankrate.com/brm/news/news_taxes_home.asp). [Date accessed: September, 11, 2008]. Other sources as indicated in footnotes.

<sup>a</sup> Connecticut levies a unified estate and gift tax which is decoupled from Federal provisions, plus an inheritance tax. The unified estate and gift tax, effective January 1, 2005, is a graduated tax with an exclusion amount of \$2 million. Donors of gifts must file a gift tax return even if no gift tax is due and estate representatives must file an estate tax return even if no estate tax is due. The inheritance tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent. Connecticut Department of Revenue Services. <http://www.ct.gov/drs/cwp/view.asp?A=1514&Q=304232>. [Date accessed: September 11, 2008].

<sup>b</sup> Connecticut repealed its succession tax effective for estates of decedents dying after December 31, 2004.

<sup>c</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out of the Federal credit put in place by the EGTRRA, the tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>d</sup> Maine has decoupled its estate tax from Federal estate tax provisions. The tax applies to estates of decedents dying after December 31, 2002. It equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2001, but recognizing an exclusion amount of \$1 million. Representatives of smaller estates must file a return if the estate is going through probate or contains real property.

<sup>e</sup> Maryland levies an estate tax which is decoupled from Federal estate tax provisions, plus an inheritance tax. The estate tax applies to estates of decedents dying after December 31, 2000. It equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of January 1, 2001, but recognizing an exclusion amount of \$1 million. The inheritance tax is a flat 10-percent levy on property passing to non-exempt individuals.

<sup>f</sup> Massachusetts has decoupled its estate tax from Federal estate tax provisions. The tax applies to estates of decedents dying after December 31, 2002. It equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2000, but recognizing an exclusion amount of \$1 million. Massachusetts Department of Revenue. <http://www.mass.gov/Ador/docs/dor/Publ/PDFS/estate08.pdf>. [Date accessed: September 11, 2008].

<sup>g</sup> New Jersey levies an estate tax which is decoupled from Federal estate tax provisions, plus an inheritance tax. The estate tax is the lesser of the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2001, or an amount determined using the State Simplified Tax System. The inheritance tax, effective July 10, 2004, is a graduated tax on property with a value of \$500 or more passing to non-exempt individuals. The New Jersey Domestic Partnership Act includes surviving domestic partners of decedents dying after July 9, 2004, as exempt individuals for inheritance tax purposes.

<sup>h</sup> New York has decoupled its estate tax from Federal estate tax provisions. The tax equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of July 22, 1998.

<sup>i</sup> Pennsylvania levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011, plus an inheritance tax. Under the phase-out of the Federal credit put in place by EGTRRA, the estate tax dropped to \$0 for estates of decedents dying after December 31, 2004. The inheritance tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent.

<sup>j</sup> Rhode Island has decoupled its estate tax from Federal estate tax provisions. The tax equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of January 1, 2001.

<sup>k</sup> Vermont has decoupled its estate tax from Federal estate tax provisions. The tax applies to estates of decedents dying after January 1, 2002, and equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of January 1, 2001.

<sup>l</sup> New Hampshire repealed its Legacy and Succession Tax effective for decedents dying after December 31, 2002.

<sup>m</sup> Connecticut replaced its gift tax with a unified estate and gift tax effective after December 31, 2004. Connecticut Department of Revenue Services. <http://www.ct.gov/drs/cwp/view.asp?A=1514&Q=304232>. [Date accessed: September 11, 2008].

<sup>n</sup> Delaware repealed its gift tax effective January 1, 1998. Delaware Division of Revenue. [http://revenue.delaware.gov/information/tims/Gift\\_Tax.shtml](http://revenue.delaware.gov/information/tims/Gift_Tax.shtml). [Date accessed: September 11, 2008].

<sup>o</sup> New York repealed its gift tax effective January 1, 2000. New York State Department of Taxation and Finance. [http://www.tax.state.ny.us/forms/prvforms/gift\\_tax\\_1983\\_1999.htm](http://www.tax.state.ny.us/forms/prvforms/gift_tax_1983_1999.htm). [Date accessed: September 11, 2008].

<sup>p</sup> The State levies a generation-skipping tax equal to the maximum Federal credit for State generation-skipping transfer taxes allowed under IRC section 2604. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 after December 31, 2004.

<sup>q</sup> Vermont has decoupled its generation-skipping tax from Federal generation-skipping transfer tax provisions. Effective January 1, 2005, Vermont levies a tax on all such transfers equal to the maximum Federal credit for State generation-skipping transfer taxes allowed under IRC section 2604 as of January 1, 2001.



Table 18.2—State transfer tax systems in the North Central region, 2008

State	Estate	Inheritance	Gift	Generation-skipping
Illinois	X <sup>a</sup>	—	—	X <sup>j</sup>
Indiana	X <sup>b</sup>	X <sup>b</sup>	—	X <sup>k</sup>
Iowa	X <sup>b</sup>	X <sup>b</sup>	—	X <sup>k</sup>
Kansas	X <sup>c</sup>	—	—	<sup>l</sup>
Michigan	X <sup>d</sup>	—	—	X <sup>k</sup>
Minnesota	X <sup>e</sup>	—	—	—
Missouri	X <sup>d</sup>	—	—	X <sup>k</sup>
Nebraska	X <sup>f</sup>	X <sup>f</sup>	—	X <sup>m</sup>
North Dakota	X <sup>d</sup>	—	—	—
Ohio	X, X <sup>g</sup>	—	—	X <sup>k</sup>
South Dakota	X <sup>d</sup>	<sup>i</sup>	—	—
Wisconsin	X <sup>h</sup>	—	—	—

Sources: CCH Financial Planning Toolkit. <http://www.finance.cch.com/text/c50s15d170.asp>. [Date accessed: September 11, 2008]. Bankrate.com State Tax Roundup. [http://www.bankrate.com/brm/news/news\\_taxes\\_home.asp](http://www.bankrate.com/brm/news/news_taxes_home.asp). [Date accessed: September 11, 2008].

<sup>a</sup> Illinois levies an estate tax which currently is decoupled from Federal estate tax provisions. For estates of decedents dying after December 31, 2005, the tax equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2001, but recognizing an exclusion amount of \$2 million. For estates of decedents dying after December 31, 2009, the tax will equal the maximum Federal credit for State transfer taxes in effect at that time.

<sup>b</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011, plus an inheritance tax. Under the phase-out of the Federal credit put in place by EGTRRA, the estate tax dropped to \$0 for estates of decedents dying after December 31, 2004. The inheritance tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent.

<sup>c</sup> Kansas has decoupled its estate tax from Federal estate tax provisions. The tax applies to estates of decedents dying after December 31, 2006, and is a graduated tax on taxable estates of more than \$1 million.

<sup>d</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>e</sup> Minnesota has decoupled its estate tax from Federal estate tax provisions. The tax equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2000.

<sup>f</sup> Nebraska levies an estate tax which is decoupled from Federal estate tax provisions, plus an inheritance tax. The estate tax applies to estates of decedents dying after June 30, 2003, and is a graduated tax on all taxable estates. The inheritance tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent.

<sup>g</sup> Ohio levies a stand-alone estate tax, plus a piggy-back estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. The stand-alone tax applies to estates of decedents dying after December 31, 2001, with a taxable value of over \$338,333. Under the phase-out of the Federal credit put in place by EGTRRA, the piggy-back estate tax dropped to \$0 for estates of decedents dying after December 31, 2004. = the tax dropped to \$0 after December 31, 2004.

<sup>h</sup> Effective January 1, 2008, Wisconsin levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out put in place by EGTRRA, the Federal credit currently is \$0. For estates of decedents dying between October 1, 2002 and December 31, 2007, Wisconsin levied an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2000.

<sup>i</sup> South Dakota repealed its inheritance tax effective June 30, 2001.

<sup>j</sup> Illinois levies a generation-skipping tax which currently is decoupled from Federal generation-skipping tax provisions. For generation-skipping transfers made after December 31, 2005, the tax equals the maximum Federal credit for State generation-skipping taxes allowed under IRC section 2604 as of December 31, 2001, but recognizing an exclusion amount of \$2 million. For generation-skipping transfers made after December 31, 2009, the tax will equal the maximum Federal credit for State transfer taxes in effect at that time.

<sup>k</sup> The State levies a generation-skipping tax equal to the maximum Federal credit for State generation-skipping transfer taxes allowed under IRC section 2604. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 after December 31, 2004.

<sup>l</sup> Kansas repealed its succession tax effective July 1, 2003

<sup>m</sup> Nebraska has decoupled from the phase-out of IRC section 2604 credit for State generation-skipping transfer taxes put in place by EGTRRA. Effective January 1, 2003, Nebraska levies a flat 16-percent tax on all taxable generation-skipping transfers.



Table 18.3—State transfer tax systems in the South, 2008

State	Estate	Inheritance	Gift	Generation-skipping
Alabama	X <sup>a</sup>	—	—	X <sup>j</sup>
Arkansas	X <sup>a</sup>	—	—	—
Florida	X <sup>a</sup>	—	—	X <sup>j</sup>
Georgia	X <sup>a</sup>	—	—	—
Kentucky	X <sup>b</sup>	X <sup>b</sup>	—	—
Louisiana	X <sup>b</sup>	X <sup>b</sup>	<sup>g</sup>	—
Mississippi	X <sup>a</sup>	—	—	—
North Carolina	X <sup>c</sup>	—	X <sup>h</sup>	X <sup>j</sup>
Oklahoma	X, X <sup>d</sup>	—	—	—
South Carolina	X <sup>a</sup>	—	—	X <sup>j</sup>
Tennessee	X <sup>e</sup>	X <sup>e</sup>	X <sup>i</sup>	X <sup>j</sup>
Texas	X <sup>a</sup>	—	—	X <sup>j</sup>
Virginia	<sup>f</sup>	—	—	X <sup>j</sup>

Sources: CCH Financial Planning Toolkit. <http://www.finance.cch.com/text/c50s15d170.asp>. [Date accessed: September 11, 2008]. Bankrate.com State Tax Roundup. [http://www.bankrate.com/brm/news/news\\_taxes\\_home.asp](http://www.bankrate.com/brm/news/news_taxes_home.asp). [Date accessed: September 11, 2008]. Other sources as indicated in footnotes.

<sup>a</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>b</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011, plus an inheritance tax. Under the phase-out of the Federal credit put in place by EGTRRA, the estate tax dropped to \$0 for estates of decedents dying after December 31, 2004. The inheritance tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent.

<sup>c</sup> North Carolina has decoupled its estate tax from Federal estate tax provisions. The tax applies to estates of decedents dying after December 31, 2004, and equals the maximum Federal credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2001. North Carolina Department of Revenue. <http://www.dornrc.com/taxes/estate/general.html>. [Date accessed: September 11, 2008].

<sup>d</sup> Oklahoma levies a stand-alone estate tax, plus a piggy-back estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. The stand-alone tax is a layered tax under which the rate varies according to a beneficiary's relation to the decedent. Under the phase-out of the Federal credit put in place by EGTRRA, the piggy-back tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>e</sup> Tennessee levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011, plus an inheritance tax. Under the phase-out of the Federal credit put in place by EGTRRA, the estate tax dropped to \$0 for decedents dying after December 31, 2004. The inheritance tax recognizes an exclusion amount of \$1 million and allows exemptions for transfers to the decedent's spouse, government entities, and charitable, educational, or religious organizations.

<sup>f</sup> Virginia repealed its estate tax, effective for the estates of decedents dying after June 30, 2007. The estates of decedents dying on or before that date were subject to an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>g</sup> Louisiana repealed its gift tax, effective for gifts made after June 30, 2008. Gifts made on or before that date are subject to a tax with annual exclusion and exemption amounts that mirror Federal gift tax provisions. Baldwin Haspel Burke & Mayer LLC. <http://www.bhbmlaw.com/alerts-updates-149.html>. [Date accessed: September 11, 2008].

<sup>h</sup> North Carolina levies a layered gift tax under which the rate varies according to a recipient's relation to the donor. North Carolina Department of Revenue. <http://www.dornrc.com/taxes/gift/>. [Date accessed: September 11, 2008].

<sup>i</sup> Tennessee levies a gift tax with an exemption that varies according to the donor's relation to the recipient. Tennessee Department of Revenue. <http://tn.gov/revenue/tntaxes/gift.htm>. [Date accessed: September 11, 2008].

<sup>j</sup> The State levies a generation-skipping tax equal to the maximum Federal credit for State generation-skipping transfer taxes allowed under IRC section 2604. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 after December 31, 2004.

Table 18.4—State transfer tax systems in the West, 2008

State	Estate	Inheritance	Gift	Generation-skipping
Alaska	X <sup>a</sup>	—	—	—
Arizona	<sup>b</sup>	—	—	<sup>b</sup>
California	X <sup>a</sup>	—	—	X <sup>f</sup>
Colorado	X <sup>a</sup>	—	—	X <sup>f</sup>
Hawaii	X <sup>a</sup>	—	—	X <sup>f</sup>
Idaho	X <sup>a</sup>	—	—	—
Montana	X <sup>a</sup>	<sup>d</sup>	—	X <sup>f</sup>
Nevada	X <sup>a</sup>	—	—	X <sup>f</sup>
New Mexico	X <sup>a</sup>	—	—	—
Oregon	—	X <sup>e</sup>	—	—
Utah	X <sup>a</sup>	—	—	—
Washington	X <sup>c</sup>	—	—	<sup>g</sup>
Wyoming	X <sup>a</sup>	—	—	—

Sources: CCH Financial Planning Toolkit. <http://www.finance.cch.com/text/c50s15d170.asp>. [Date accessed: September 11, 2008]. Bankrate.com State Tax Roundup. [http://www.bankrate.com/brm/news/news\\_taxes\\_home.asp](http://www.bankrate.com/brm/news/news_taxes_home.asp). [Date accessed: September 11, 2008].

<sup>a</sup> The State levies an estate tax equal to the maximum Federal credit for State transfer taxes allowed under IRC section 2011. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 for estates of decedents dying after December 31, 2004.

<sup>b</sup> Arizona permanently repealed its estate and generation-skipping taxes, effective for tax years beginning after December 31, 2005.

<sup>c</sup> Washington has decoupled its estate tax from the Federal estate tax provisions. The tax is a graduated tax on estates of decedents dying after May 16, 2005. The first \$1.5 million of the taxable estate of decedents dying between May 17 and December 31, 2005, and the first \$2 million of the taxable estate of decedents dying after that period, are exempt from the tax.

<sup>d</sup> Montana repealed its inheritance tax, effective for tax years beginning after December 31, 2000.

<sup>e</sup> Oregon has decoupled its inheritance tax from Federal provisions. Effective for tax years beginning after December 31, 2005, the tax equals the maximum credit for State transfer taxes allowed under IRC section 2011 as of December 31, 2000, but recognizing an exclusion amount of \$1 million.

<sup>f</sup> The State levies a generation-skipping tax equal to the maximum Federal credit for State generation-skipping transfer taxes allowed under IRC section 2604. Under the phase-out of the Federal credit put in place by EGTRRA, the tax dropped to \$0 after December 31, 2004.

<sup>g</sup> Washington repealed its generation-skipping tax, effective May 17, 2005.

Overall, 32 States—4 in the Northeast, 7 in the North Central region, 11 in the South, and 10 in the West—have kept estate or inheritance taxes tied to the Federal credit on their books, allowing them to phase out. Two States—one each in the South and West—have repealed estate taxes tied to the Federal credit (tables 18.1 through 18.4).

Seven States—Minnesota, New Jersey, New York, North Carolina, Rhode Island, Vermont, and Wisconsin—have decoupled estate or inheritance taxes from the current Federal estate tax provisions, tying them to Federal law as it existed on January 1, 2002, or earlier. Another five States—Illinois, Maine, Maryland, Massachusetts, and Oregon—also have decoupled estate or inheritance taxes from current Federal estate tax provisions, tying them to Federal law as it existed December 31, 2001, or earlier, but recognizing a higher exclusion amount. And four States—Connecticut, Kansas, Nebraska, and Washington—have replaced taxes tied to the Federal credit with stand-alone estate taxes (tables 18.1 through 18.4).

The net result of these changes is that 34 States that once levied estate or inheritance taxes tied to the Federal credit no longer do so, at least for the present. Only the 16 States listed in the preceding paragraph still levy estate or inheritance taxes descended from tax laws tied to the Federal credit—12 by decoupling their tax from current Federal law and 4 by passing a new stand-alone tax (tables 18.1 through 18.4).

**Stand-alone inheritance and estate taxes**—Montana, New Hampshire, and South Dakota have repealed stand-alone inheritance or estate taxes. Twelve States—Connecticut, Indiana, Iowa, Kentucky, Louisiana, Maryland, Nebraska, New Jersey, Ohio, Oklahoma, Pennsylvania, and Tennessee—still levy taxes of this type (tables 18.1 through 18.4).

**Gift taxes**—Delaware, Louisiana, and New York have repealed their gift taxes, while Connecticut has replaced its gift tax with a unified estate and gift tax. Only North Carolina and Tennessee continue to levy gift taxes (tables 18.1 and 18.3).

**Generation-skipping transfer taxes**—Of the States that levied generation-skipping transfer taxes at the time the last edition of this book was published, 21 have allowed their taxes to phase out with the Federal credit, while Arizona, Kansas, and Washington have repealed their laws. Only Illinois, Nebraska, and Vermont still levy generation-skipping transfer taxes. Illinois and Vermont decoupled their taxes from current Federal provisions, tying them to Federal law as in effect on an earlier date—although Illinois recognizes a higher exclusion amount. Nebraska replaced a tax tied to Federal law with a stand-alone tax (tables 18.1 through 18.4).

## State Transfer Taxes and Estate Planning

The specific provisions of State transfer taxes differ substantially, even among States with similar tax systems. In most instances, coordinated planning that takes both Federal and State tax provisions into consideration will be required in order to obtain the best results.

The need for coordinated planning is, of course, reduced to the extent that a specific State has repealed transfer taxes or allowed them to phase out with the Federal credit. The latter situation will likely change, however, as Congress addresses the 1-year repeal of the Federal estate tax and subsequent return to prior law scheduled under EGTRRA.

Coordinated planning will continue to be necessary in States that have decoupled from current Federal law and tied their transfer taxes to provisions that existed at an earlier date, as well as in States that have retained or enacted stand-alone transfer taxes. In States that have decoupled from current Federal law, provisions such as the applicable credit amount (provided by IRC section 2010; see chapter 3), marital deduction (provided by IRC section 2056(a); see chapter 6), special use valuation (permitted under IRC section 2032A; see chapter 12), and deferral and extension of tax payments (permitted under IRC section 6166; see chapter 13) remain available indirectly at the State level. The marital deduction is not limited, but for the other provisions the level of the benefit is that in effect on the date to which the State tax is tied rather than that provided under current Federal law.

In States that have retained or enacted stand-alone taxes, the provisions available may be quite different from those allowed under Federal law. Some States do not have applicable credit or marital deduction provisions, with the result that estate value deferred at the Federal level may be taxable by the State. Some States have their own special use valuation and deferral and extension provisions, while others lack such provisions or explicitly deny them. Thus, in States which have decoupled from current Federal provisions, and in those with stand-alone taxes, a State estate or inheritance tax may be incurred even if no Federal estate tax is due. Trusts, joint ownerships, aggressive gifting (including charitable bequests), intergenerational transfers, and other measures discussed elsewhere in this book also produce mixed results when State transfer tax provisions are not explicitly incorporated in the planning process.

Because of the increasing variability in State transfer tax laws and because some State laws work counter to Federal provisions, it is imperative that estate planners be familiar with the details of State transfer taxes and how they impact forest properties.

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## Chapter 19

### The Benefit of Planning a Forest Estate— or the Cost of Not Planning

The following examples, although loosely based on real circumstances, are hypothetical. They are used to illustrate some of the principles that have been presented in this book.

#### Hypothetical Family Timberland

A husband and wife, both in their 80s, have enjoyed success with their investments in forest land. Over their life together, they have accumulated assets with a value of \$10 million. These include a house and lot worth \$300,000; 2,000 acres of forest land with a fair market value (FMV) of \$3 million for the land alone; standing timber worth \$5 million; life insurance policies with a face value of \$700,000; and \$1 million in stocks. The life insurance policies consist of a \$500,000 policy on the husband with a cash value of \$200,000 and a \$200,000 policy on the wife with a cash value of \$100,000. The husband holds title to all the assets—including both life insurance policies—so he can take timely advantage of investment opportunities as they arise. On the negative side, he also has \$700,000 in business debts.

The forest land is very productive, but its value for timber production is well below its FMV for more developed uses. Nevertheless, the couple wants to keep the land in forest for their three married children and five grandchildren. Their other objectives are to ensure that, regardless of which of them is the first to die, the surviving spouse will be well cared for, and that their family, rather than the Federal government, benefits from their success. Assume that: (1) \$75,000 in final medical and funeral expenses is incurred at each death; (2) administrative costs equal 5 percent of the gross estate, minus debts and final expenses; (3) the children's marriages are sound; and (4) the family works together harmoniously.

What impact will the Federal estate tax have on the family assets if the owner dies intestate (without a will) in 2008 and his wife dies later in the same year? In 2010? In 2015? Assume that State laws of descent and distribution require that half of the entire estate go to the surviving spouse, with the remaining half divided equally among the children.

#### Example 19.1—No Estate Plan

**First death**—The gross estate at the owner's death is \$9,900,000 (\$300,000 house and lot + \$3,000,000 timberland + \$5,000,000 standing timber + \$500,000 face

value of the insurance policy on himself + \$100,000 cash value of the insurance policy on his wife + \$1,000,000 in securities). The adjusted gross estate is \$8,668,750 (\$9,900,000 gross estate – \$700,000 business debts – \$75,000 hospital and funeral expenses – \$456,250 administrative cost). The administrative cost is calculated as 5 percent of the adjusted gross estate, after debts and final expenses. This may be high for an estate of this size; however, it probably is low for an unplanned estate.

Half of the estate—\$4,334,375 ( $\$8,668,750 \times 0.50$ )—goes to the wife. It is protected by the marital deduction and any estate tax on it is deferred until her death or other changes occur. The other half goes to the children. It is assumed that they engage competent professional advisors who help them qualify for special use valuation which reduces the FMV of their estate to \$3,374,375 ( $\$4,334,375 - \$960,000$ ; see chapter 12). Of this, \$2,000,000 is shielded by the applicable exclusion amount. The tax on the remainder is \$618,469 ( $\$1,374,375 \times 0.45$ ). The tax is due within nine months unless an extension is granted under Internal Revenue Code (IRC) section 6166 or for other reasons as discussed in chapter 13.

The estate tax and administrative costs due after the husband's death total \$1,074,719 (\$618,469 estate tax + \$456,250 administrative cost). This solution also leaves the surviving wife with access to only half of the couple's combined estate, which she helped to accumulate. There are unnecessary taxes, such as those on the face value of the life insurance policy on the husband and on the cash value of the policy on the wife. The size of the estate tax and administrative costs, combined with the division of the property, may well interrupt timber management and the continuity of the family forest enterprise.

**Second death**—What happens if the wife dies later in 2008? Her gross estate is \$4,334,375. After subtracting final expenses and administrative costs, the adjusted taxable estate is \$4,046,406 ( $\$4,334,375$  gross estate – \$75,000 final expenses – \$212,969 administrative cost). There is no marital deduction, but special use valuation can be used to reduce the taxable estate to \$3,086,406 ( $\$4,046,406 - \$960,000$ ). Of this, \$2,000,000 is shielded by the applicable exclusion amount. The tax on the remainder is \$488,883 ( $\$1,086,406 \times 0.45$ ). The combined estate tax for both deaths is \$1,107,352 ( $\$618,469 + \$488,883$ ). Thus, although this solution fortuitously took advantage of the marital deduction

at the first death, two allowable credits, and two elections to use special use valuation, the lack of a plan resulted in estate taxes equal to nearly one-eighth of the original estate.

If the wife lives until 2010, there will be no Federal estate tax under current law, due to the 1-year repeal of the tax for that year. All estate assets—minus final expenses and administrative costs—will pass tax free to the children.

If the wife lives until 2015, current law calls for the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) to sunset and the Federal estate tax provisions to revert to those in place before 2002. Although it seems likely that Congress will address the situation before this occurs, it remains possible that the allowable credit will be substantially lower and estate tax rates higher after 2010. As it is, there is enough uncertainty that the most common sense strategy would be to keep the family's forest assets flexible as well as productive by avoiding irreversible situations.

### Example 19.2—A Simple Plan

**First death**—What happens if the husband neglects actual estate planning, but has his attorney draft a will specifying that if he is the first to die, everything goes to his wife? This arrangement sometimes is called an “I Love You” will (assume this distribution is permitted under State law). At the husband's death, the marital deduction again reduces the adjusted taxable estate to \$0 and no tax is owed. The tax is not eliminated, however, but simply deferred. Now the questions become: what happens if the wife dies later in 2008? And what happens if the wife dies first?

As above, after deducting business debts, hospital and funeral expenses, and the 5 percent administrative cost, the husband's adjusted gross estate is \$8,668,750. Because of the unlimited marital deduction, the entire amount goes to the surviving wife and no Federal estate tax is due.

**Second death**—If the wife dies later in the same year, her adjusted gross estate is \$8,164,062 (\$8,668,750 gross estate – \$75,000 final expenses – \$429,688 administrative cost). As before there is no marital deduction, but the executor can elect to use special use valuation to reduce the taxable estate to \$7,204,062 (\$8,164,062 – \$960,000). An estate tax of \$2,341,828 [(\$7,204,062 – \$2,000,000) x 0.45] is due—nearly one-fourth of the original combined estate. This huge tax bill is due in 9 months although deferral and extension is possible, as discussed in chapter 13. This solution ignores the needs of the children. Further, it shields only \$2 million from tax instead of \$4 million, and provides only one opportunity to elect special use valuation instead of two.

Since the husband held title to all family assets, the results are the same if the wife is the first to die. Although it recognizes the contribution of both spouses to the family's financial success, the “I Love You” will wastes the opportunity to use the allowable credit and to elect special use valuation at the death of the first spouse, resulting in an unnecessarily large estate tax bill.

*The results in both these examples are unsatisfactory because each fails to consider the needs of some family members and results in excessive amount of estate tax. What if the couple had worked with estate planners familiar with forest land assets to evaluate other possible solutions?*

### Example 19.3—A Balanced Estate Plan

**Equalize ownership of family assets**—Assuming a full inventory of the family assets is in hand, the first step toward a more balanced estate plan is to equalize asset ownership between the husband and wife. This is necessary to take full advantage of two estate planning tools: the special use valuation election available under IRC section 2032A, discussed here, and formula marital deduction wills, discussed below. Ideally, there is sufficient trust and skill for the husband to gift ownership of a full half of the family assets to the wife. More than simply balancing the dollar value of the spouses' individual estates, the gift should include sufficient land and timber to take advantage of the special use valuation election at each spouse's death, regardless of whom is the first to die. In this example, at the husband's death in 2008 a special use valuation election could reduce his taxable estate by up to \$960,000 compared to the simple plan, saving up to \$432,000 (\$960,000 x 0.45) in estate tax.

**Remove the insurance policies from the husband's estate**—Both life insurance policies should be removed from the husband's estate, by transferring ownership either to a trusted child (this option is possible only if the family works together harmoniously) or to an irrevocable life insurance trust with the children and grandchildren as beneficiaries (an aggressive plan also could include the children's spouses, but that option depends on the family culture). Depending on the spouses' expected longevity, the transfer could be made using the annual gift tax exclusion of \$24,000 per beneficiary per year for split gifts and/or a portion of the husband's lifetime gift tax exclusion of \$1 million. Use of the gift tax exclusion may be advisable here, to remove the life insurance policies from the husband's estate as quickly as possible. This would remove \$600,000 (\$500,000 face value of the policy on the husband + \$100,000 cash value of the policy on the wife) in taxable value from his estate at a cost of using \$300,000 (\$200,000



cash value of the policy on the husband + \$100,000 cash value of the policy on the wife) of his gift tax exclusion.

In this example the transfer would have had to be made in 2005 or earlier, since under IRC section 2042 the transfer of a life insurance policy only is effective if made 3 years before the transferor's death; had this been the case, it could save up to \$270,000 ( $\$600,000 \times 0.45$ ) in estate tax compared to the simple plan.

**Formula marital deduction wills**—Both spouses should have wills structured to take advantage of the applicable exclusion amount at each death, regardless of whom is the first to die, as discussed in chapter 9 and illustrated in figure 9.1. At the death of the first spouse, the children would receive a bequest equal to the full amount shielded from estate tax by the applicable exclusion amount, and the surviving spouse would receive the balance of the estate. This would remove the amount shielded by the applicable exclusion—\$2 million in 2008 and \$3.5 million in 2009—from the surviving spouse's estate. If there was any question whether the assets remaining to the surviving spouse are sufficient, the bequest to the children could be made in the form of a bypass trust that provides the surviving spouse a life interest in the trust proceeds and perhaps the right to invade the trust principal, subject to an ascertainable standard of living; otherwise, the bequest to the children could be made outright. In this example, at the husband's death in 2008, a formula marital deduction will could remove \$1,700,000 ( $\$2,000,000$  applicable exclusion amount –  $\$300,000$  part of the applicable exclusion amount used to gift the life insurance policies) from his estate compared to the simple plan, saving up to \$765,000 ( $\$1,700,000 \times 0.45$ ) in estate tax.

*Fully used and timely implemented, these three strategies could reduce the family estate tax bill by nearly \$1.5 million compared to the simple plan. But the family still faces considerable estate tax exposure.*

*If the spouses' health permits, they should consider organizing the forest enterprise as a Family Limited Partnership (FLP; see chapter 15) or Limited Liability Company (LLC; see chapter 17). This would solidify the business purpose of the forest land and facilitate the transfer of FLP partnership interests or LLC membership interests equal to the annual gift tax exclusion (or double with split gifts). At least initially, the gifts would be of minority interests and could contain marketing constraints—such as, ownership must be kept within the family—that would allow valuation discounts varying from 20 to 50 percent. For example, a 50 percent discount would allow the couple to transfer \$48,000 (2008, as indexed) to each donee in discounted, split interests. If they made such gifts to each of their three children, \$144,000 per year could be transferred. If they added their five grandchildren, a total of \$384,000 per year could be transferred, and if they added their children's spouses, \$528,000 per year could be transferred.*

*With a \$10 million family estate earning an expected \$600,000 to \$800,000 per year, perhaps an aggressive gifting plan should be considered. With an FLP, the husband and wife could retain control and the heirs would be passive limited partners; with an LLC, all members who desire to could become active participants. There are numerous options depending on family health, cohesion, and goals that permit business continuity and keep the family forest together. In the absence of family harmony, other alternatives might be necessary. The strategies described above will save taxes and keep the forest assets productive. When some family elements are missing, various types of trusts provide alternative methods to meet these needs.*





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## Appendix I

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Internal Revenue Code section 2704  
Treasury Regulation 25.2704-2(b)

## **Chapter 16**

Internal Revenue Code section 179  
Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)  
IRS Form 2553, Election by a Small Business Corporation  
Private Letter Ruling 9111036, December 17, 1991

## **Chapter 17**

Hackl, C.M. v. Commissioner, 118 TC 279, affirmed 335 F.3rd 664 (CA-7), 2003-2 USTC ¶60,465

## Chapter 18

Haney, H.L., Jr.; Siegel, W.C. 1993. Estate Planning for Forest Landowners: What will Become of Your Timberland? Gen. Tech. Rep. SO-97. New Orleans. LA. U.S. Department of Agriculture Forest Service, Southern Forest Experiment Station. 186 p.

Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16)

Internal Revenue Code section 2011

Internal Revenue Code section 2604

Internal Revenue Code section 2010

Internal Revenue Code section 2056(a)

Internal Revenue Code section 2032A

Internal Revenue Code section 6166

CCH Financial Planning Toolkit, <http://www.finance.cch.com/text/c50s15d170.asp>

Bankrate.com State Tax Roundup, [http://www.bankrate.com/brm/news/news\\_taxes\\_home.asp](http://www.bankrate.com/brm/news/news_taxes_home.asp)

Connecticut Department of Revenue Services, <http://www.ct.gov/drs/cwp/view.asp?A=1514&Q=304232>

Massachusetts Department of Revenue, <http://www.mass.gov/Ador/docs/dor/Publ/PDFS/estate08.pdf>

Delaware Division of Revenue, [http://revenue.delaware.gov/information/tims/Gift\\_Tax.shtml](http://revenue.delaware.gov/information/tims/Gift_Tax.shtml)

New York State Department of Taxation and Finance, [http://www.tax.state.ny.us/forms/prvforms/gift\\_tax\\_1983\\_1999.htm](http://www.tax.state.ny.us/forms/prvforms/gift_tax_1983_1999.htm)

North Carolina Department of Revenue, <http://www.dornrc.com/taxes/estate/general.html>

Baldwin Haspel Burke & Mayer LLC, <http://www.bhbmlaw.com/alerts-updates-149.html>

North Carolina Department of Revenue, <http://www.dornrc.com/taxes/gift/>

Tennessee Department of Revenue, <http://tn.gov/revenue/tntaxes/gift.htm>

## Chapter 19

Internal Revenue Code section 6166

Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16)

Internal Revenue Code section 2032A

Internal Revenue Code section 2042

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## Appendix II

### Glossary

**Adjusted gross estate:** The gross estate, less funeral expenses, expenses of estate administration during probate, debts of the estate, and casualty losses suffered during estate administration.

**Administration:** The care and management of an estate by a trustee, guardian, administrator, or executor.

**Administrator:** A male person appointed by the court to administer the estate of a deceased person who (1) dies leaving no will, or (2) leaves a will naming an executor or executors who for some reason cannot serve. The functions of an administrator are to collect assets of the estate, pay debts, and distribute residue to those entitled to it.

**Administratrix:** The female counterpart of an administrator. See also “administrator.”

**Agent:** A person who acts for another person by the latter’s authority.

**Alternate valuation date:** The earlier of the date six months after the decedent’s death or the date any estate asset is sold. Estate assets may be valued as of the alternate valuation date instead of the date of the decedent’s death if doing so both decreases the value of the gross estate and results in a decrease in the net Federal estate tax payable. If the alternate valuation date is elected, all estate assets must be valued as of that date. See also “basis” and “stepped-up basis.”

**Amortization:** Paying off a loan by regular installments.

**Ancillary administration:** Probate administration of property (usually real property) owned in a State other than the one in which the decedent had his (her) principal residence at the time of death.

**Annuity:** A periodic (usually annual) payment of a fixed sum of money for either the life of the recipient or for a fixed number of years.

**Appraisal:** A determination of property value.

**Assets:** (1) The property comprising the estate of a deceased person, or (2) the property in a trust account.

**Attorney-at-law:** A person who is legally qualified and licensed to practice law, and to represent and act for clients in legal proceedings.

**Attorney-in-fact:** A person who, acting as an agent, is given written authorization by another person to transact business for him (her) out of court.

**Basis:** A measure of an owner’s investment in a capital asset used for tax purposes. An owner’s original basis in an asset acquired by purchase is the total cost of acquisition; in an asset acquired by inheritance, the fair market value on the decedent’s date of death or the alternate valuation date; and in an asset acquired by gift, the donor’s basis or the fair market value, whichever is lower. See also “alternate valuation date,” “fair market value,” and “stepped-up basis.”

**Beneficiary:** A person or institution named in a will or other legal document to receive property or property benefits.

**Bequeath:** To gift property by will.

**Bequest:** Property gifted by will.

**Bond:** An agreement under which a person or corporation (such as an insurance company) becomes surety to pay, within stated limits, for financial loss caused to a second person or legal entity by the act or default of a third person—such as loss to an estate by action of the administrator.

**Charity:** An agency, institution, or organization in existence and operating for the benefit of an indefinite number of persons and conducted for educational, religious, scientific, medical, or other beneficent purposes.

**Codicil:** An addition, change, or supplement to a will executed with the same formalities required for the will itself.

**Common disaster:** A sudden and extraordinary misfortune that brings about the simultaneous or near-simultaneous deaths of two or more associated persons, such as husband and wife.

**Contemplation of death:** The expectation of death that provides the primary motive to make a gift.

**Contingent beneficiary:** Receiver of property or benefits if the first named beneficiary fails to receive any or all of the property or benefits in question before his (her) death.

**Contract:** A legal written agreement that becomes binding when signed.

**Corporation:** A legal entity owned by the holders of shares of stock that have been issued, and that can own, receive, and transfer property, and carry on business in its own name.

**Curtsey:** A widower's legal interest in his wife's real estate.

**Decedent:** A deceased person.

**Deed:** The legal instrument used to transfer title in real property from one person to another.

**Dependent:** A person dependent for support upon another.

**Descendent:** One who is directly descended from another such as a child, grandchild, or great grandchild.

**Devise:** To gift property by will.

**Distribution:** The appointment of personal property or its proceeds to those entitled to receive it under the terms of a will or trust.

**Donee:** The recipient of a gift.

**Donor:** The person who makes a gift.

**Dower:** A widow's legal interest in her deceased husband's real estate.

**Escrow:** Money given to a third party to be held for payment until certain conditions are met.

**Estate:** All real and personal property and property rights owned by a person.

**Executor:** A male person named in a will to carry out the decedent's directions, administer the decedent's estate, and distributes the decedent's property in accordance with the will.

**Executrix:** The female counterpart of an executor. See also "executor."

**Fair market value:** The price at which an asset would change hands in a transaction between a willing, informed buyer and a willing, informed seller.

**Fee simple:** Absolute title to property with no limitations or restrictions regarding the person who may inherit it.

**Fiduciary:** A trustee, executor, or administrator.

**Gift:** A voluntary transfer or conveyance of property without consideration, or for less than full and adequate consideration based on fair market value.

**Grantor:** The person who establishes a trust and places property into it.

**Gross estate:** The total fair market value of all property and property interests, real and personal, tangible and intangible, of which a decedent had beneficial ownership at the time of death before subtractions for deductions, debts, administrative expenses, and casualty losses suffered during estate administration.

**Guardian:** A person legally empowered and charged with the duty of taking care of and managing the property of another person who because of age, intellect, or health, is incapable of managing his (her) own affairs.

**Heir:** One entitled, by law, to inherit the property of a decedent who died without a will.

**Intangible property:** Property that has no intrinsic value, but is merely the evidence of value such as stock certificates, bonds, and promissory notes.

**Intestate:** Dying without leaving a will.

**Inter vivos:** Transfer of property from one living person to another living person.

**Irrevocable trust:** A trust arrangement that cannot be revoked, rescinded, or repealed by the grantor.

**Joint tenancy:** A form of property ownership in which two or more parties hold an undivided interest in the same property that was conveyed under the same instrument at the same time. A joint tenant can sell his (her) interest but not dispose of it by will. Upon the death of a joint tenant, his (her) undivided interest is distributed among the surviving joint tenants.

**Law of descent:** The State statutes that specify how a deceased person's property is to be divided among the decedent's heirs if there is no will.

**Legacy:** A gift of property made by will.

**Legatee:** A beneficiary of a decedent's property named in the decedent's will.

**Liabilities:** The aggregate of all debts and other legal obligations of a particular person or legal entity.

**Lien:** A claim against real or personal property in satisfaction of a debt.

**Life estate:** A property interest limited in duration to the life of the individual holding the interest (life tenant).

**Lineal descendant:** Direct descendant of the same ancestors.

**Marital deduction:** The deduction(s) that can be taken in the determination of gift and estate tax liabilities because of the existence of a marriage or marital relationship.

**Mortgage:** The written agreement pledging property to a creditor as collateral for a loan.

**Mortgagee:** The person to whom property is mortgaged and who has loaned the money.

**Mortgagor:** The person who pledges property to a creditor as collateral for a loan and who receives the money.

**Partnership:** A voluntary contract between two or more persons to pool some or all of their assets into a business, with the agreement that there will be a proportional sharing of profits and losses.

**Personal property:** All property that is not real property.

**Per stirpes:** The legal means by which the children of a decedent, upon the death of an ancestor at a level above that of the decedent, receive by right of representation the share of the ancestor's estate that their parent would have received if living.

**Probate:** Proving a will's validity to the court and securing authority from the court to carry out the will's provisions. Also used in a broad sense to mean administration of a decedent's estate.

**Real property:** Land, and all immovable fixtures erected on, growing on, or affixed to the land.

**Remainder:** An interest in property that takes effect in the future at a specified time or after the occurrence of some event, such as the death of a life tenant.

**Remainderman:** One entitled to the remainder of an estate after a particular reserved right or interest, such as a life tenancy, has expired.

**Revocable trust:** A trust agreement that can be canceled, rescinded, revoked, or repealed by the grantor (person who establishes the trust).

**Right of survivorship:** The ownership rights that result in the acquisition of title to property by reason of having survived other co-owners.

**Sole ownership:** The type of property ownership in which one individual holds legal title to the property and has full control of it.

**Stepped-up basis:** The basis of an asset acquired by inheritance is its fair market value on the date of the decedent's death or the alternative valuation date. This generally is higher than the basis of the asset when held by the decedent, resulting in a "stepped-up" basis to the person who inherits it. See also "alternative valuation date," "basis," and "fair market value."

**Tenancy in common:** A type of property ownership in which two or more individuals have an undivided interest in property. At the death of one tenant in common, his (her) fractional percentage of ownership in the property passes to the decedent's heirs rather than to the surviving tenants in common. Also called nonspousal joint tenancy.

**Tenancy by the entirety:** A type of joint tenancy between husband and wife that is recognized in some States. Neither party can sever the joint tenancy relationship; when a spouse dies, the survivor acquires full title to the property.

**Terminal interest:** A conditional interest in property that terminates or fails after a period of time or on the occurrence, or failure to occur, of an event or contingency. Examples include interests that lapse on the remarriage or death of the recipient. See also "terminal interest rule."

**Terminal interest rule:** Under Internal Revenue Code section 2056(b), no marital deduction is allowed for a property interest that is a terminal interest. See also "terminal interest."

**Testate:** To die leaving a will.

**Testator:** A male person who leaves a will at death.

**Testatrix:** The female counterpart of a testator.

**Trust:** An arrangement made during life or under the terms of a will by which a property interest is held by one party (the trustee) for the benefit of one or more beneficiaries.

**Trustee:** A person or institution holding and administering property in trust.

**Trustor:** The person who makes or creates a trust. Also known as the grantor or settlor.

**Will:** A legal declaration of the manner in which a person wishes to distribute his (her) estate after death.





**Appendix III**

**IRS Form 706—United States Estate  
(and Generation-Skipping Transfer) Tax Return**



Form **706**  
(Rev. August 2008)

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

OMB No. 1545-0015

Department of the Treasury  
Internal Revenue Service

**Estate of a citizen or resident of the United States (see separate instructions).  
To be filed for decedents dying after December 31, 2007, and before January 1, 2009.**

<b>Part 1—Decedent and Executor</b>	<b>1a</b> Decedent's first name and middle initial (and maiden name, if any)	<b>1b</b> Decedent's last name	<b>2</b> Decedent's Social Security No.		
	<b>3a</b> County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	<b>3b</b> Year domicile established	<b>4</b> Date of birth	<b>5</b> Date of death	
	<b>6a</b> Name of executor (see page 4 of the instructions)	<b>6b</b> Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.			
	<b>6c</b> Executor's social security number (see page 5 of the instructions)				
	Phone no. ( )				<b>7b</b> Case number
	<b>7a</b> Name and location of court where will was probated or estate administered				
<b>8</b> If decedent died testate, check here <input type="checkbox"/> and attach a certified copy of the will. <b>9</b> If you extended the time to file this Form 706, check here <input type="checkbox"/>					
<b>10</b> If Schedule R-1 is attached, check here <input type="checkbox"/>					

<b>Part 2—Tax Computation</b>	<b>1</b> Total gross estate less exclusion (from Part 5—Recapitulation, page 3, item 12)	<b>1</b>		
	<b>2</b> Tentative total allowable deductions (from Part 5—Recapitulation, page 3, item 22)	<b>2</b>		
	<b>3a</b> Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)	<b>3a</b>		
	<b>b</b> State death tax deduction	<b>3b</b>		
	<b>c</b> Taxable estate (subtract line 3b from line 3a)	<b>3c</b>		
	<b>4</b> Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))	<b>4</b>		
	<b>5</b> Add lines 3c and 4	<b>5</b>		
	<b>6</b> Tentative tax on the amount on line 5 from Table A on page 4 of the instructions	<b>6</b>		
	<b>7</b> Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)	<b>7</b>		
	<b>8</b> Gross estate tax (subtract line 7 from line 6)	<b>8</b>		
	<b>9</b> Maximum unified credit (applicable credit amount) against estate tax	<b>9</b>		
	<b>10</b> Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed \$6,000. See page 6 of the instructions.)	<b>10</b>		
	<b>11</b> Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)	<b>11</b>		
	<b>12</b> Subtract line 11 from line 8 (but do not enter less than zero)	<b>12</b>		
	<b>13</b> Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	<b>13</b>		
	<b>14</b> Credit for tax on prior transfers (from Schedule Q)	<b>14</b>		
	<b>15</b> Total credits (add lines 13 and 14)	<b>15</b>		
	<b>16</b> Net estate tax (subtract line 15 from line 12)	<b>16</b>		
	<b>17</b> Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)	<b>17</b>		
	<b>18</b> Total transfer taxes (add lines 16 and 17)	<b>18</b>		
<b>19</b> Prior payments. Explain in an attached statement	<b>19</b>			
<b>20</b> Balance due (or overpayment) (subtract line 19 from line 18)	<b>20</b>			

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.

<b>Sign Here</b>			
<b>Paid Preparer's Use Only</b>	Preparer's signature	Date	Check if self-employed <input type="checkbox"/>
	Firm's name (or yours if self-employed), address, and ZIP code	EIN	Preparer's SSN or PTIN
		Phone no. ( )	

Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**Part 3—Elections by the Executor**

Please check the "Yes" or "No" box for each question (see instructions beginning on page 6).

		Yes	No
<b>Note.</b> Some of these elections may require the posting of bonds or liens.			
<b>1</b> Do you elect alternate valuation?	<b>1</b>		
<b>2</b> Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1.	<b>2</b>		
<b>3</b> Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described on pages 10 and 11 of the instructions. <b>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.</b>	<b>3</b>		
<b>4</b> Do you elect to postpone the part of the taxes attributable to a reversionary or remainder interest as described in section 6163?	<b>4</b>		

**Part 4—General Information** (Note. Please attach the necessary supplemental documents. You must attach the death certificate.)  
(see instructions on page 12)

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 if return prepared by an attorney, accountant, or enrolled agent for the executor:

Name of representative (print or type)	State	Address (number, street, and room or suite no., city, state, and ZIP code)	
I declare that I am the <input type="checkbox"/> attorney/ <input type="checkbox"/> certified public accountant/ <input type="checkbox"/> enrolled agent (you must check the applicable box) for the executor and prepared this return 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.
- 3** Marital status of the decedent at time of death:
  - Married
  - Widow or widower—Name, SSN, and date of death of deceased spouse ▶ .....
  - Single
  - Legally separated
  - Divorced—Date divorce decree became final ▶ .....

<b>4a</b> Surviving spouse's name	<b>4b</b> Social security number	<b>4c</b> Amount received (see page 12 of the instructions)
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**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** .....

Please check the "Yes" or "No" box for each question.		Yes	No
<b>6</b> Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate) (see page 12 of the instructions)?			
<b>7a</b> Have federal gift tax returns ever been filed? If "Yes," please attach copies of the returns, if available, and furnish the following information:			
<b>7b</b> Period(s) covered	<b>7c</b> Internal Revenue office(s) where filed		
<b>8a</b> Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?			
<b>b</b> Did the decedent own any insurance on the life of another that is not included in the gross estate?			

(continued on next page)

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**Part 4—General Information** *(continued)*

If you answer "Yes" to any of questions 9–16, you must attach additional information as described in the instructions.		Yes	No
<b>9</b>	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which <b>(a)</b> one or more of the other joint tenants was someone other than the decedent's spouse, and <b>(b)</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 . . . . .		
<b>10a</b>	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>b</b>	If "Yes," was the value of <b>any</b> interest owned (from above) discounted on this estate tax return? If "Yes," see the instructions for Schedule F on page 20 for reporting the total accumulated or effective discounts taken on Schedule F or G . . . . .		
<b>11</b>	Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G beginning on page 15 of the separate instructions)? If "Yes," you must complete and attach Schedule G . . . . .		
<b>12a</b>	Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime? . . . . .		
<b>b</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? . . . . .		
<b>c</b>	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) upon the death of the decedent? . . . . .		
<b>d</b>	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).		
<b>e</b>	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 question 12a or 12b? . . . . . If "Yes," provide the EIN number to this transferred/sold item. ▶		
<b>13</b>	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		
<b>14</b>	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? . . . . .		
<b>15</b>	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 . . . . .		
<b>16</b>	Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation . . . . .		

**Part 5—Recapitulation**

Item number	Gross estate	Alternate value	Value at date of death
<b>1</b>	Schedule A—Real Estate . . . . .	<b>1</b>	
<b>2</b>	Schedule B—Stocks and Bonds . . . . .	<b>2</b>	
<b>3</b>	Schedule C—Mortgages, Notes, and Cash . . . . .	<b>3</b>	
<b>4</b>	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712) . . . . .	<b>4</b>	
<b>5</b>	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance) . . . . .	<b>5</b>	
<b>6</b>	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance) . . . . .	<b>6</b>	
<b>7</b>	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance) . . . . .	<b>7</b>	
<b>8</b>	Schedule H—Powers of Appointment . . . . .	<b>8</b>	
<b>9</b>	Schedule I—Annuities . . . . .	<b>9</b>	
<b>10</b>	Total gross estate (add items 1 through 9) . . . . .	<b>10</b>	
<b>11</b>	Schedule U—Qualified Conservation Easement Exclusion . . . . .	<b>11</b>	
<b>12</b>	Total gross estate less exclusion (subtract item 11 from item 10). Enter here and on line 1 of Part 2—Tax Computation . . . . .	<b>12</b>	
Item number	Deductions	Amount	
<b>13</b>	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims . . . . .	<b>13</b>	
<b>14</b>	Schedule K—Debts of the Decedent . . . . .	<b>14</b>	
<b>15</b>	Schedule K—Mortgages and Liens . . . . .	<b>15</b>	
<b>16</b>	Total of items 13 through 15 . . . . .	<b>16</b>	
<b>17</b>	Allowable amount of deductions from item 16 (see the instructions for item 17 of the Recapitulation) . . . . .	<b>17</b>	
<b>18</b>	Schedule L—Net Losses During Administration . . . . .	<b>18</b>	
<b>19</b>	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims . . . . .	<b>19</b>	
<b>20</b>	Schedule M—Bequests, etc., to Surviving Spouse . . . . .	<b>20</b>	
<b>21</b>	Schedule O—Charitable, Public, and Similar Gifts and Bequests . . . . .	<b>21</b>	
<b>22</b>	Tentative total allowable deductions (add items 17 through 21). Enter here and on line 2 of the Tax Computation	<b>22</b>	



Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**SCHEDULE A—Real Estate**

- For jointly owned property that must be disclosed on Schedule E, see the instructions on the reverse side of Schedule E.
- 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 section 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.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules or additional sheets attached to this schedule . . .				
<b>TOTAL.</b> (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 sheets of the same size.)  
(See the instructions on the reverse side.)

Form 706 (Rev. 8-2008)

**Instructions for Schedule A—Real Estate**

If the total gross estate contains any real estate, you must complete Schedule A and file it with the return. On Schedule A, list real estate the decedent owned or had contracted to purchase. Number each parcel in the left-hand column.

Describe the real estate in enough detail so that the IRS can easily locate it for inspection and valuation. For each parcel of real estate, report the area and, if the parcel is improved, describe the improvements. For city or town property, report the street and number, ward, subdivision, block and lot, etc. For rural property, report the township, range, landmarks, etc.

If any item of real estate is subject to a mortgage for which the decedent's estate is liable; that is, if the indebtedness may be charged against other property of the estate that is not subject to that mortgage, or if the decedent was personally liable for that mortgage, you must report the full value of the property in the value

column. Enter the amount of the mortgage under "Description" on this schedule. The unpaid amount of the mortgage may be deducted on Schedule K.

If the decedent's estate is not liable for the amount of the mortgage, report only the value of the equity of redemption (or value of the property less the indebtedness) in the value column as part of the gross estate. Do not enter any amount less than zero. Do not deduct the amount of indebtedness on Schedule K.

Also list on Schedule A real property the decedent contracted to purchase. Report the full value of the property and not the equity in the value column. Deduct the unpaid part of the purchase price on Schedule K.

Report the value of real estate without reducing it for homestead or other exemption, or the value of dower, curtesy, or a statutory estate created instead of dower or curtesy.

Explain how the reported values were determined and attach copies of any appraisals.

**Schedule A Examples**

**In this example, alternate valuation is not adopted; the date of death is January 1, 2008.**

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	House and lot, 1921 William Street NW, Washington, DC (lot 6, square 481). Rent of \$8,100 due at end of each quarter, February 1, May 1, August 1, and November 1. Value based on appraisal, copy of which is attached . . . . .			\$550,000
	Rent due on item 1 for quarter ending November 1, 2007, but not collected at date of death . . . . .			8,100
	Rent accrued on item 1 for November and December 2007 . . . . .			5,400
2	House and lot, 304 Jefferson Street, Alexandria, VA (lot 18, square 40). Rent of \$1,800 payable monthly. Value based on appraisal, copy of which is attached . . . . .			375,000
	Rent due on item 2 for December 2007, but not collected at date of death . . . . .			1,800

**In this example, alternate valuation is adopted; the date of death is January 1, 2008.**

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1	House and lot, 1921 William Street NW, Washington, DC (lot 6, square 481). Rent of \$8,100 due at end of each quarter, February 1, May 1, August 1, and November 1. Value based on appraisal, copy of which is attached. Not disposed of within 6 months following death . . . . .	7/1/08	\$535,000	\$550,000
	Rent due on item 1 for quarter ending November 1, 2007, but not collected until February 1, 2008 . . . . .	2/1/08	8,100	8,100
	Rent accrued on item 1 for November and December 2007, collected on February 1, 2008 . . . . .	2/1/08	5,400	5,400
2	House and lot, 304 Jefferson Street, Alexandria, VA (lot 18, square 40). Rent of \$1,800 payable monthly. Value based on appraisal, copy of which is attached. Property exchanged for farm on May 1, 2008 . . . . .	5/1/08	369,000	375,000
	Rent due on item 2 for December 2007, but not collected until February 1, 2008 . . . . .	2/1/08	1,800	1,800

**Schedule A—Page 5**

Form 706 (Rev. 8-2008)

## Instructions for Schedule A-1. Section 2032A Valuation

The election to value certain farm and closely held business property at its special-use value is made by checking "Yes" to Form 706, Part 3—Elections by the Executor, line 2. Schedule A-1 is used to report the additional information that must be submitted to support this election. In order to make a valid election, you must complete Schedule A-1 and attach all of the required statements and appraisals.

For definitions and additional information concerning special-use valuation, see section 2032A and the related regulations.

### Part 1. Type of Election

**Estate and GST tax elections.** If you elect special-use valuation for the estate tax, you must also elect special-use valuation for the GST tax and *vice versa*.

You must value each specific property interest at the same value for GST tax purposes that you value it at for estate tax purposes.

**Protective election.** To make the protective election described in the separate instructions for Part 3—Elections by the Executor, line 2, you must check this box, enter the decedent's name and social security number in the spaces provided at the top of Schedule A-1, and complete *Part 2. Notice of Election*, line 1 and lines 3 and 4, column A. For purposes of the protective election, list on line 3 all of the real property that passes to the qualified heirs even though some of the property will be shown on line 2 when the additional notice of election is subsequently filed. You need not complete columns B through D of lines 3 and 4. You need not complete any other line entries on Schedule A-1. Completing Schedule A-1 as described above constitutes a Notice of Protective Election as described in Regulations section 20.2032A-8(b).

### Part 2. Notice of Election

**Line 10.** Because the special-use valuation election creates a potential tax liability for the recapture tax of section 2032A(c), you must list each person who receives an interest in the specially valued property on Schedule A-1. If there are more than eight persons who receive interests, use an additional sheet that follows the format of line 10. In the columns "Fair market value" and "Special-use value," you should enter the total respective values of all the specially valued property interests received by each person.

### GST Tax Savings

To compute the additional GST tax due upon disposition (or cessation of qualified use) of the property, each "skip person" (as defined in the instructions to Schedule R) who receives an interest in the specially valued property must know the total GST tax savings on all of the interests in specially valued property received. This GST tax savings is the difference between the total GST tax that was imposed on all of the interests in specially valued property received by the skip person valued at their special-use value and the total GST tax that would have been imposed on the same interests received by the skip person had they been valued at their fair market value.

Because the GST tax depends on the executor's allocation of the GST exemption and the grandchild exclusion, the skip person who receives the interests is unable to compute this GST tax savings. Therefore, for each skip person who receives an interest in specially valued property, you must attach worksheets showing the total GST tax savings attributable to all of that person's interests in specially valued property.

**How to compute the GST tax savings.** Before computing each skip person's GST tax savings, you must complete Schedules R and R-1 for the entire estate (using the special-use values).

For each skip person, you must complete two Schedules R (Parts 2 and 3 only) as worksheets, one showing the interests in

specially valued property received by the skip person at their special-use value and one showing the same interests at their fair market value.

If the skip person received interests in specially valued property that were shown on Schedule R-1, show these interests on the Schedule R, Parts 2 and 3 worksheets, as appropriate. Do not use Schedule R-1 as a worksheet.

**Completing the special-use value worksheets.** On Schedule R, Parts 2 and 3, lines 2 through 4 and 6, enter -0-.

**Completing the fair market value worksheets.**

- *Schedule R, Parts 2 and 3, lines 2 and 3, fixed taxes and other charges.* If valuing the interests at their fair market value (instead of special-use value) causes any of these taxes and charges to increase, enter the increased amount (only) on these lines and attach an explanation of the increase. Otherwise, enter -0-.

- *Schedule R, Parts 2 and 3, line 6—GST exemption allocation.* If you completed Schedule R, Part 1, line 10, enter on line 6 the amount shown for the skip person on the line 10 special-use allocation schedule you attached to Schedule R. If you did not complete Schedule R, Part 1, line 10, enter -0- on line 6.

**Total GST tax savings.** For each skip person, subtract the tax amount on line 10, Part 2 of the special-use value worksheet from the tax amount on line 10, Part 2 of the fair market value worksheet. This difference is the skip person's total GST tax savings.

### Part 3. Agreement to Special Valuation Under Section 2032A

The agreement to special valuation by persons with an interest in property is required under section 2032A(a)(1)(B) and (d)(2) and must be signed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death.

An interest in property is an interest that, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person who at the decedent's death has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included are owners of remainder and executory interests; the holders of general or special powers of appointment; beneficiaries of a gift over in default of exercise of any such power; joint tenants and holders of similar undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued; and trustees of trusts and representatives of other entities holding title to, or holding any interests in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

If any person required to enter into the agreement either desires that an agent act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, or due to death before the election under section 2032A is timely exercised, a representative authorized by local law to bind the person in an agreement of this nature may sign the agreement on his or her behalf.

The Internal Revenue Service will contact the agent designated in the agreement 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. It is the duty of the agent as attorney-in-fact for the parties with interests in the specially valued property to furnish the IRS with any requested information and to notify the IRS of any disposition or cessation of qualified use of any part of the property.

**Checklist for Section 2032A Election**

*If you are going to make the special-use valuation election on Schedule A-1, please use this checklist to ensure that you are providing everything necessary to make a valid election.*

To have a valid special-use valuation election under section 2032A, you must file, in addition to the federal estate tax return, (a) a notice of election (Schedule A-1, Part 2), and (b) a fully executed agreement (Schedule A-1, Part 3). You must include certain information in the notice of election. To ensure that the notice of election includes all of the information required for a valid election, use the following checklist. The checklist is for your use only. Do not file it with the return.

1. Does the notice of election include the decedent's name and social security number as they appear on the estate tax return?

2. Does the notice of election include the relevant qualified use of the property to be specially valued?

3. Does the notice of election describe the items of real property shown on the estate tax return that are to be specially valued and identify the property by the Form 706 schedule and item number?

4. Does the notice of election include the fair market value of the real property to be specially valued and also include its value based on the qualified use (determined without the adjustments provided in section 2032A(b)(3)(B))?

5. Does the notice of election include the adjusted value (as defined in section 2032A(b)(3)(B)) of (a) all real property that both passes from the decedent and is used in a qualified use, without regard to whether it is to be specially valued, and (b) all real property to be specially valued?

6. Does the notice of election include (a) the items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and that are used in qualified use and (b) the total value of such personal property adjusted under section 2032A(b)(3)(B)?

7. Does the notice of election include the adjusted value of the gross estate? (See section 2032A(b)(3)(A).)

8. Does the notice of election include the method used to determine the special-use value?

9. Does the notice of election include copies of written appraisals of the fair market value of the real property?

10. Does the notice of election include a statement that the decedent and/or a member of his or her family has owned all of the specially valued property for at

least 5 years of the 8 years immediately preceding the date of the decedent's death?

11. Does the notice of election include a statement as to whether there were any periods during the 8-year period preceding the decedent's date of death during which the decedent or a member of his or her family did not (a) own the property to be specially valued, (b) use it in a qualified use, or (c) materially participate in the operation of the farm or other business? (See section 2032A(e)(6).)

12. Does the notice of election include, for each item of specially valued property, the name of every person taking an interest in that item of specially valued property and the following information about each such person: (a) the person's address, (b) the person's taxpayer identification number, (c) the person's relationship to the decedent, and (d) the value of the property interest passing to that person based on both fair market value and qualified use?

13. Does the notice of election include affidavits describing the activities constituting material participation and the identity of the material participants?

14. Does the notice of election include a legal description of each item of specially valued property? (In the case of an election made for qualified woodlands, the information included in the notice of election must include the reason for entitlement to the Woodlands election.)

Any election made under section 2032A will not be valid unless a properly executed agreement (Schedule A-1, Part 3) is filed with the estate tax return. To ensure that the agreement satisfies the requirements for a valid election, use the following checklist.

1. Has the agreement been signed by each and every qualified heir having an interest in the property being specially valued?

2. Has every qualified heir expressed consent to personal liability under section 2032A(c) in the event of an early disposition or early cessation of qualified use?

3. Is the agreement that is actually signed by the qualified heirs in a form that is binding on all of the qualified heirs having an interest in the specially valued property?

4. Does the agreement designate an agent to act for the parties to the agreement in all dealings with the IRS on matters arising under section 2032A?

5. Has the agreement been signed by the designated agent and does it give the address of the agent?

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : : : :
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**SCHEDULE A-1—Section 2032A Valuation**

**Part 1. Type of Election** (Before making an election, see the checklist on page 7.):

- 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 checklist on page 7 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 and every 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)
<b>Totals</b> . . . . .			

**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)
<b>Totals</b> . . . . .			

**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 . . . . .		<b>Total adjusted value</b> . . . . .	

**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
<b>a</b> Did not own the property listed on line 2? . . . . .		
<b>b</b> Did not use the property listed on line 2 in a qualified use? . . . . .		
<b>c</b> 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, 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.



Form 706 (Rev. 8-2008)

### Part 3. Agreement to Special Valuation Under Section 2032A

<b>Estate of:</b>	<b>Decedent's Social Security Number</b>
	: : : :

There cannot be a valid election unless:

- The agreement is executed by each and every 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 of the Code 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) of the Code 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 of the Code 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 of the Code 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 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)*

Form 706 (Rev. 8-2008)

**Part 3. Agreement to Special Valuation Under Section 2032A** *(continued)*

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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• 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.

Name of Agent	Signature	Address
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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 \_\_\_\_\_ .

**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

Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**SCHEDULE B—Stocks and Bonds**

(For jointly owned property that must be disclosed on Schedule E, see the instructions for Schedule E.)

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 sheets) attached to this schedule . . .						
<b>TOTAL.</b> (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 sheets of the same size.)  
 (The instructions to Schedule B are in the separate instructions.)

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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**SCHEDULE C—Mortgages, Notes, and Cash**

(For jointly owned property that must be disclosed on Schedule E, see the instructions for Schedule E.)

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules (or additional sheets) attached to this schedule . . .				
<b>TOTAL.</b> (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 sheets of the same size.)  
(See the instructions on the reverse side.)

Form 706 (Rev. 8-2008)

## Instructions for Schedule C— Mortgages, Notes, and Cash

Complete Schedule C and file it with your return if the total gross estate contains any:

- Mortgages,
- Notes, or
- Cash.

List on Schedule C:

- Mortgages and notes payable **to the decedent** at the time of death.
- Cash the decedent had at the date of death.

Do not list on Schedule C:

- Mortgages and notes payable **by the decedent**. (If these are deductible, list them on Schedule K.)

List the items on Schedule C in the following order:

1. Mortgages;
2. Promissory notes;
3. Contracts by decedent to sell land;
4. Cash in possession; and
5. Cash in banks, savings and loan associations, and other types of financial organizations.

### What to enter in the “Description” column:

For mortgages, list:

- Face value,
- Unpaid balance,
- Date of mortgage,
- Name of maker,
- Property mortgaged,
- Date of maturity,
- Interest rate, and
- Interest date.

### Example to enter in “Description” column:

“Bond and mortgage of \$50,000, unpaid balance: \$17,000; dated: January 1, 1992; John Doe to Richard Roe; premises: 22 Clinton Street, Newark, NJ; due: January 1, 2012; interest payable at 10% a year—January 1 and July 1.”

For promissory notes, list in the same way as mortgages.

For contracts by the decedent to sell land, list:

- Name of purchaser,
- Contract date,
- Property description,
- Sale price,
- Initial payment,
- Amounts of installment payment,
- Unpaid balance of principal, and
- Interest rate.

For cash in possession, list such cash separately from bank deposits.

For cash in banks, savings and loan associations, and other types of financial organizations, list:

- Name and address of each financial organization,
- Amount in each account,
- Serial or account number,
- Nature of account—checking, savings, time deposit, etc., and
- Unpaid interest accrued from date of last interest payment to the date of death.

**Note.** If you obtain statements from the financial organizations, keep them for IRS inspection.

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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**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.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules (or additional sheets) attached to this schedule . .				
<b>TOTAL.</b> (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 sheets of the same size.)  
(See the instructions on the reverse side.)



Form 706 (Rev. 8-2008)

## Instructions for Schedule D—Insurance on the Decedent's Life

If you are required to file Form 706 and there was any insurance on the decedent's life, whether or not included in the gross estate, you must complete Schedule D and file it with the return.

**Insurance you must include on Schedule D.** Under section 2042, you must include in the gross estate:

- Insurance on the decedent's life receivable by or for the benefit of the estate; and
- Insurance on the decedent's life receivable by beneficiaries other than the estate, as described below.

The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficiary societies operating under the lodge system, and death benefits paid under no-fault automobile insurance policies if the no-fault insurer was unconditionally bound to pay the benefit in the event of the insured's death.

**Insurance in favor of the estate.** Include on Schedule D the full amount of the proceeds of insurance on the life of the decedent receivable by the executor or otherwise payable to or for the benefit of the estate. Insurance in favor of the estate includes insurance used to pay the estate tax, and any other taxes, debts, or charges that are enforceable against the estate. The manner in which the policy is drawn is immaterial as long as there is an obligation, legally binding on the beneficiary, to use the proceeds to pay taxes, debts, or charges. You must include the full amount even though the premiums or other consideration may have been paid by a person other than the decedent.

**Insurance receivable by beneficiaries other than the estate.** Include on Schedule D the proceeds of all insurance on the life of the decedent not receivable by or for the benefit of the decedent's estate if the decedent possessed at death any of the incidents of ownership, exercisable either alone or in conjunction with any person.

Incidents of ownership in a policy include:

- The right of the insured or estate to its economic benefits;
- The power to change the beneficiary;

- The power to surrender or cancel the policy;
- The power to assign the policy or to revoke an assignment;
- The power to pledge the policy for a loan;
- The power to obtain from the insurer a loan against the surrender value of the policy; and
- A reversionary interest if the value of the reversionary interest was more than 5% of the value of the policy immediately before the decedent died. (An interest in an insurance policy is considered a reversionary interest if, for example, the proceeds become payable to the insured's estate or payable as the insured directs if the beneficiary dies before the insured.)

Life insurance not includible in the gross estate under section 2042 may be includible under some other section of the Code. For example, a life insurance policy could be transferred by the decedent in such a way that it would be includible in the gross estate under section 2036, 2037, or 2038. See the instructions to Schedule G for a description of these sections.

### Completing the Schedule

You must list every policy of insurance on the life of the decedent, whether or not it is included in the gross estate.

Under "Description," list:

- The name of the insurance company, and
- The number of the policy.

For every policy of life insurance listed on the schedule, you must request a statement on Form 712, Life Insurance Statement, from the company that issued the policy. Attach the Form 712 to the back of Schedule D.

If the policy proceeds are paid in one sum, enter the net proceeds received (from Form 712, line 24) in the value (and alternate value) columns of Schedule D. If the policy proceeds are not paid in one sum, enter the value of the proceeds as of the date of the decedent's death (from Form 712, line 25).

If part or all of the policy proceeds are not included in the gross estate, you must explain why they were not included.

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : :
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**SCHEDULE E—Jointly Owned Property**

(If you elect section 2032A valuation, you must complete Schedule E and Schedule A-1.)

**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	Alternate valuation date	Alternate value	Value at date of death
1	CUSIP number or EIN, where applicable			
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .				
<b>1a</b> Totals . . . . .			<b>1a</b>	
<b>1b</b> Amounts included in gross estate (one-half of line 1a) . . . . .			<b>1b</b>	

**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 sheet.

Name	Address (number and street, city, state, and ZIP code)
<b>A.</b>	
<b>B.</b>	
<b>C.</b>	

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	Percentage includible	Includible alternate value	Includible value at date of death
1		CUSIP number or EIN, where applicable			
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .					
<b>2b</b> Total other joint interests . . . . .			<b>2b</b>		
<b>3</b> Total includible joint interests (add lines 1b and 2b). Also enter on Part 5—Recapitulation, page 3, at item 5 . . . . .			<b>3</b>		

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(See the instructions on the reverse side.)

Form 706 (Rev. 8-2008)

## Instructions for Schedule E—Jointly Owned Property

If you are required to file Form 706, you must complete Schedule E and file it with the return if the decedent owned any joint property at the time of death, whether or not the decedent's interest is includible in the gross estate.

Enter on this schedule all property of whatever kind or character, whether real estate, personal property, or bank accounts, in which the decedent held at the time of death an interest either as a joint tenant with right to survivorship or as a tenant by the entirety.

Do not list on this schedule property that the decedent held as a tenant in common, but report the value of the interest on Schedule A if real estate, or on the appropriate schedule if personal property. Similarly, community property held by the decedent and spouse should be reported on the appropriate Schedules A through I. The decedent's interest in a partnership should not be entered on this schedule unless the partnership interest itself is jointly owned. Solely owned partnership interests should be reported on Schedule F, "Other Miscellaneous Property Not Reportable Under Any Other Schedule."

**Part 1. Qualified joint interests held by decedent and spouse.** Under section 2040(b)(2), a joint interest is a qualified joint interest if the decedent and the surviving spouse held the interest as:

- Tenants by the entirety, or
- Joint tenants with right of survivorship if the decedent and the decedent's spouse are the only joint tenants.

Interests that meet either of the two requirements above should be entered in Part 1. Joint interests that do not meet either of the two requirements above should be entered in Part 2.

Under "Description," describe the property as required in the instructions for Schedules A, B, C, and F for the type of property involved. For example, jointly held stocks and bonds should be described using the rules given in the instructions to Schedule B.

Under "Alternate value" and "Value at date of death," enter the full value of the property.

**Note.** You cannot claim the special treatment under section 2040(b) for property held jointly by a decedent and a surviving spouse who is not a U.S. citizen. You must report these joint interests on Part 2 of Schedule E, not Part 1.

**Part 2. All other joint interests.** All joint interests that were not entered in Part 1 must be entered in Part 2.

For each item of property, enter the appropriate letter A, B, C, etc., from line 2a to indicate the name and address of the surviving co-tenant.

Under "Description," describe the property as required in the instructions for Schedules A, B, C, and F for the type of property involved.

In the "Percentage includible" column, enter the percentage of the total value of the property that you intend to include in the gross estate.

Generally, you must include the full value of the jointly owned property in the gross estate. However, the full value should not be included if you can show that a part of the property originally belonged to the other tenant or tenants and was never received or acquired by the other tenant or tenants from the decedent for less than adequate and full consideration in money or money's worth, or unless you can show that any part of the property was acquired with consideration originally belonging to the surviving joint tenant or tenants. In this case, you may exclude from the value of the property an amount proportionate to the consideration furnished by the other tenant or tenants. Relinquishing or promising to relinquish dower, curtesy, or statutory estate created instead of dower or curtesy, or other marital rights in the decedent's property or estate is not consideration in money or money's worth. See the Schedule A instructions for the value to show for real property that is subject to a mortgage.

If the property was acquired by the decedent and another person or persons by gift, bequest, devise, or inheritance as joint tenants, and their interests are not otherwise specified by law, include only that part of the value of the property that is figured by dividing the full value of the property by the number of joint tenants.

If you believe that less than the full value of the entire property is includible in the gross estate for tax purposes, you must establish the right to include the smaller value by attaching proof of the extent, origin, and nature of the decedent's interest and the interest(s) of the decedent's co-tenant or co-tenants.

In the "Includible alternate value" and "Includible value at date of death" columns, you should enter only the values that you believe are includible in the gross estate.

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<b>Estate of:</b>	<b>Decedent's Social Security Number</b>
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**SCHEDULE F—Other Miscellaneous Property Not Reportable Under Any Other Schedule**

(For jointly owned property that must be disclosed on Schedule E, see the instructions for Schedule E.)  
 (If you elect section 2032A valuation, you must complete Schedule F and Schedule A-1.)

	Yes	No
<b>1</b> Did the decedent at the time of death own any works of art or items with collectible value in excess of \$3,000 or any collections whose artistic or collectible value combined at date of death exceeded \$10,000? . . . . . If "Yes," submit full details on this schedule and attach appraisals.	<input type="checkbox"/>	<input type="checkbox"/>
<b>2</b> 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.	<input type="checkbox"/>	<input type="checkbox"/>
<b>3</b> Did the decedent at the time of death have, or have access to, a safe deposit box? . . . . . If "Yes," state location, and if held in joint names of 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.	<input type="checkbox"/>	<input type="checkbox"/>

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
<b>1</b>	CUSIP number or EIN, where applicable			
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .				
<b>TOTAL.</b> (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 sheets of the same size.)  
 (See the instructions on the reverse side.)

Form 706 (Rev. 8-2008)

## Instructions for Schedule F—Other Miscellaneous Property

### You must complete Schedule F and file it with the return.

On Schedule F, list all items that must be included in the gross estate that are not reported on any other schedule, including:

- Debts due the decedent (other than notes and mortgages included on Schedule C);
- Interests in business;
- Any interest in an Archer medical savings account (MSA) or health savings account (HSA), unless such interest passes to the surviving spouse; and
- Insurance on the life of another (obtain and attach Form 712, Life Insurance Statement, for each policy).

**Note (for single premium or paid-up policies).** In certain situations, for example where the surrender value of the policy exceeds its replacement cost, the true economic value of the policy will be greater than the amount shown on line 59 of Form 712. In these situations, you should report the full economic value of the policy on Schedule F. See Rev. Rul. 78-137, 1978-1 C.B. 280 for details.

- Section 2044 property (see *Decedent Who Was a Surviving Spouse* below);
- Claims (including the value of the decedent's interest in a claim for refund of income taxes or the amount of the refund actually received);
- Rights;
- Royalties;
- Leaseholds;
- Judgments;
- Reversionary or remainder interests;
- Shares in trust funds (attach a copy of the trust instrument);
- Household goods and personal effects, including wearing apparel;
- Farm products and growing crops;
- Livestock;
- Farm machinery; and
- Automobiles.

**Interests.** If the decedent owned any interest in a partnership or unincorporated business, attach a statement of assets and liabilities for the valuation date and for the 5 years before the valuation date. Also, attach statements of the net earnings for the same 5 years. Be sure to include the EIN of the entity. You must account for goodwill in the valuation. In general, furnish the same information and follow the methods used to value close corporations. See the instructions for Schedule B.

All partnership interests should be reported on Schedule F unless the partnership interest, itself, is jointly owned. Jointly owned partnership interests should be reported on Schedule E.

If real estate is owned by the sole proprietorship, it should be reported on Schedule F and not on Schedule A. Describe the real estate with the same detail required for Schedule A.

**Valuation discounts.** If you answered "Yes" to Part 4—General Information, line 10b for any interest in miscellaneous property not reportable under any other

### Schedule F—Page 20

schedule owned by the decedent at the time of death, attach a statement which lists the item number from Schedule F and identifies the total accumulated discount taken (that is, XX.XX%) on such interest.

If you answered "Yes" to line 10b for an interest in a limited liability company owned by the decedent at the time of death, attach a statement which lists the item number from Schedule F and identifies the effective discount taken on such interest.

#### Example of effective discount:

<b>a</b>	Pro-rata value of limited liability company (before any discounts)	\$100.00
<b>b</b>	Minus: 10% discounts for lack of control	(10.00)
<b>c</b>	Marketable minority interest value (as if freely traded minority interest value)	\$90.00
<b>d</b>	Minus: 15% discount for lack of marketability	(13.50)
<b>e</b>	Non-marketable minority interest value	\$76.50

Calculation of effective discount:

<b>(a minus e) divided by a = effective discount</b>
(\$100.00 - \$76.50) ÷ \$100.00 = 23.50%

**Note.** The amount of discounts are based on the factors pertaining to a specific interest and those discounts shown in the example are for demonstration purposes only.

If you answered "Yes" to line 10b for any transfer(s) described in (1) through (5) on pages 15 and 16 of the separate Form 706 instructions (and made by the decedent), **attach a statement to Schedule G** which lists the item number from that schedule and identifies the total accumulated discount taken (that is, XX.XX%) on such transfer(s).

**Line 1.** If the decedent owned at the date of death works of art or items with collectible value (for example, jewelry, furs, silverware, books, statuary, vases, oriental rugs, coin or stamp collections), check the "Yes" box on line 1 and provide full details. If any one work of art or item with collectible value is valued at more than \$3,000, or any collection of similar articles is valued at more than \$10,000, attach an appraisal by an expert under oath and the required statement regarding the appraiser's qualifications (see Regulations section 20.2031-6(b)).

### Decedent Who Was a Surviving Spouse

If the decedent was a surviving spouse, he or she may have received qualified terminable interest property (QTIP) from the predeceased spouse for which the marital deduction was elected either on the predeceased spouse's estate tax return or on a gift tax return, Form 709. The election was available for gifts made and decedents dying after December 31, 1981. List such property on Schedule F.

If this election was made and the surviving spouse retained his or her interest in the QTIP property at death, the full value of the QTIP property is includible in his or her estate, even though the qualifying income interest terminated at death. It is valued as of the date of the surviving spouse's death, or alternate valuation date, if applicable. Do not reduce the value by any annual exclusion that may have applied to the transfer creating the interest.

The value of such property included in the surviving spouse's gross estate is treated as passing from the surviving spouse. It therefore qualifies for the charitable and marital deductions on the surviving spouse's estate tax return if it meets the other requirements for those deductions.

For additional details, see Regulations section 20.2044-1.

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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**SCHEDULE G—Transfers During Decedent's Life**

(If you elect section 2032A valuation, you must complete Schedule G and Schedule A-1.)

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
<b>A.</b>	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>B.</b>	Transfers includible under section 2035(a), 2036, 2037, or 2038:			
<b>1</b>				
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .				
<b>TOTAL.</b> (Also enter on Part 5—Recapitulation, page 3, at item 7.) . . . . .				

**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.)

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
<b>1</b>				
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .				
<b>TOTAL.</b> (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 sheets of the same size.)  
(The instructions to Schedules G and H are in the separate instructions.)



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<b>Estate of:</b>	<b>Decedent's Social Security Number</b>
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**SCHEDULE I—Annuities**

**Note.** Generally, no exclusion is allowed for the estates of decedents dying after December 31, 1984 (see page 17 of the instructions).

<b>A</b> 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)? . . . . .	<b>Yes</b>	<b>No</b>
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
<b>1</b>				

Total from continuation schedules (or additional sheets) attached to this schedule . . . . .	
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<b>TOTAL.</b> (Also enter on Part 5—Recapitulation, page 3, at item 9.) . . . . .	
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(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
**Schedule I—Page 22** (The instructions to Schedule I are in the separate instructions.)

Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**SCHEDULE J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims**

**Note.** Do not list on this schedule expenses of administering property not subject to claims. For those expenses, see the instructions for Schedule L.

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 if a waiver is filed to waive the deduction on Form 706 (see the Form 1041 instructions).

Item number	Description	Expense amount	Total amount
1	<b>A. Funeral expenses:</b>		
	Total funeral expenses . . . . .	▶	
	<b>B. Administration expenses:</b>		
	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 sheets) attached to this schedule . . . . .		
	Total miscellaneous expenses . . . . .	▶	
	<b>TOTAL.</b> (Also enter on Part 5—Recapitulation, page 3, at item 13.) . . . . .		▶

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
 (See the instructions on the reverse side.)

Form 706 (Rev. 8-2008)

## Instructions for Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims

**General.** You must complete and file Schedule J if you claim a deduction on item 13 of Part 5—Recapitulation.

On Schedule J, itemize funeral expenses and expenses incurred in administering property subject to claims. List the names and addresses of persons to whom the expenses are payable and describe the nature of the expense. **Do not list expenses incurred in administering property not subject to claims on this schedule. List them on Schedule L instead.**

The deduction is limited to the amount paid for these expenses that is allowable under local law but may not exceed:

1. The value of property subject to claims included in the gross estate, plus
2. The amount paid out of property included in the gross estate but not subject to claims. This amount must actually be paid by the due date of the estate tax return.

The applicable local law under which the estate is being administered determines which property is and is not subject to claims. If under local law a particular property interest included in the gross estate would bear the burden for the payment of the expenses, then the property is considered property subject to claims.

Unlike certain claims against the estate for debts of the decedent (see the instructions for Schedule K in the separate instructions), you cannot deduct expenses incurred in administering property subject to claims on both the estate tax return and the estate's income tax return. If you choose to deduct them on the estate tax return, you cannot deduct them on a Form 1041 filed for the estate. Funeral expenses are only deductible on the estate tax return.

**Funeral expenses.** Itemize funeral expenses on line A. Deduct from the expenses any amounts that were reimbursed, such as death benefits payable by the Social Security Administration and the Veterans Administration.

**Executors' commissions.** When you file the return, you may deduct commissions that have actually been paid to you or that you expect will be paid. You may not deduct commissions if none will be collected. If the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the final examination of the return, provided that:

- The Estate and Gift Tax Territory Manager is reasonably satisfied that the commissions claimed will be paid;
- The amount entered as a deduction is within the amount allowable by the laws of the jurisdiction where the estate is being administered; and
- It is in accordance with the usually accepted practice in that jurisdiction for estates of similar size and character.

If you have not been paid the commissions claimed at the time of the final examination of the return, you must

support the amount you deducted with an affidavit or statement signed under the penalties of perjury that the amount has been agreed upon and will be paid.

You may not deduct a bequest or devise made to you instead of commissions. If, however, the decedent fixed by will the compensation payable to you for services to be rendered in the administration of the estate, you may deduct this amount to the extent it is not more than the compensation allowable by the local law or practice.

Do not deduct on this schedule amounts paid as trustees' commissions whether received by you acting in the capacity of a trustee or by a separate trustee. If such amounts were paid in administering property not subject to claims, deduct them on Schedule L.

**Note.** Executors' commissions are taxable income to the executors. Therefore, be sure to include them as income on your individual income tax return.

**Attorney fees.** Enter the amount of attorney fees that have actually been paid or that you reasonably expect to be paid. If on the final examination of the return, the fees claimed have not been awarded by the proper court and paid, the deduction will be allowed provided the Estate and Gift Tax Territory Manager is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable payment for the services performed, taking into account the size and character of the estate and the local law and practice. If the fees claimed have not been paid at the time of final examination of the return, the amount deducted must be supported by an affidavit, or statement signed under the penalties of perjury, by the executor or the attorney stating that the amount has been agreed upon and will be paid.

Do not deduct attorney fees incidental to litigation incurred by the beneficiaries. These expenses are charged against the beneficiaries personally and are not administration expenses authorized by the Code.

**Interest expense.** Interest expenses incurred after the decedent's death are generally allowed as a deduction if they are reasonable, necessary to the administration of the estate, and allowable under local law.

Interest incurred as the result of a federal estate tax deficiency is a deductible administrative expense. Penalties are not deductible even if they are allowable under local law.

**Note.** If you elect to pay the tax in installments under section 6166, you may not deduct the interest payable on the installments.

**Miscellaneous expenses.** Miscellaneous administration expenses necessarily incurred in preserving and distributing the estate are deductible. These expenses include appraiser's and accountant's fees, certain court costs, and costs of storing or maintaining assets of the estate.

The expenses of selling assets are deductible only if the sale is necessary to pay the decedent's debts, the expenses of administration, or taxes, or to preserve the estate or carry out distribution.

Form 706 (Rev. 8-2008)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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**SCHEDULE K—Debts of the Decedent, and Mortgages and Liens**

Item number	Debts of the Decedent—Creditor and nature of claim, and allowable death taxes	Amount unpaid to date	Amount in contest	Amount claimed as a deduction
1				
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .				
<b>TOTAL.</b> (Also enter on Part 5—Recapitulation, page 3, at item 14.) . . . . .				

Item number	Mortgages and Liens—Description	Amount
1		
Total from continuation schedules (or additional sheets) attached to this schedule . . . . .		
<b>TOTAL.</b> (Also enter on Part 5—Recapitulation, page 3, at item 15.) . . . . .		

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
 (The instructions to Schedule K are in the separate instructions.) **Schedule K—Page 25**

Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**SCHEDULE L—Net Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims**

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 sheets) attached to this schedule . . . . .		

**TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 18.) . . . . .

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 sheets) attached to this schedule . . . . .		

**TOTAL.** (Also enter on Part 5—Recapitulation, page 3, at item 19.) . . . . .

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
**Schedule L—Page 26** (The instructions to Schedule L are in the separate instructions.)

Form 706 (Rev. 8-2008)

Decedent's Social Security Number

Estate of:

**SCHEDULE M—Bequests, etc., to Surviving Spouse**

**Election To Deduct Qualified Terminable Interest Property Under Section 2056(b)(7).** If a trust (or other property) meets the requirements of qualified terminable interest property under section 2056(b)(7), and

- a. The trust or other property is listed on Schedule M and
- b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule M, then unless the executor specifically identifies the trust (all or a fractional portion or percentage) or other property to be excluded from the election, the executor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2056(b)(7).

If less than the entire value of the trust (or other property) that the executor has included in the gross estate is entered as a deduction on Schedule M, the executor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule M. The denominator is equal to the total value of the trust (or other property).

**Election To Deduct Qualified Domestic Trust Property Under Section 2056A.** If a trust meets the requirements of a qualified domestic trust under section 2056A(a) and this return is filed no later than 1 year after the time prescribed by law (including extensions) for filing the return, and

- a. The entire value of a trust or trust property is listed on Schedule M and
- b. The entire value of the trust or trust property is entered as a deduction on Schedule M, then unless the executor specifically identifies the trust to be excluded from the election, the executor shall be deemed to have made an election to have the entire trust treated as qualified domestic trust property.

		Yes	No
<b>1</b>	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).	<b>1</b>	
<b>2a</b>	In what country was the surviving spouse born? _____		
<b>b</b>	What is the surviving spouse's date of birth? _____		
<b>2c</b>	Is the surviving spouse a U.S. citizen? . . . . .		
<b>d</b>	If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship? _____		
<b>e</b>	If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen? _____		
<b>3</b>	<b>Election Out of QTIP Treatment of Annuities.</b> 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) . . . . .	<b>3</b>	

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
<b>A1</b>	QTIP property:	
<b>B1</b>	All other property:	

Total from continuation schedules (or additional sheets) attached to this schedule . . . . .

<b>4</b>	<b>Total</b> amount of property interests listed on Schedule M . . . . .	<b>4</b>	
<b>5a</b>	Federal estate taxes payable out of property interests listed on Schedule M . . . . .	<b>5a</b>	
<b>b</b>	Other death taxes payable out of property interests listed on Schedule M . . . . .	<b>5b</b>	
<b>c</b>	Federal and state GST taxes payable out of property interests listed on Schedule M . . . . .	<b>5c</b>	
<b>d</b>	Add items 5a, 5b, and 5c . . . . .	<b>5d</b>	
<b>6</b>	Net amount of property interests listed on Schedule M (subtract 5d from 4). Also enter on Part 5—Recapitulation, page 3, at item 20 . . . . .	<b>6</b>	

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(See the instructions on the reverse side.)



Form 706 (Rev. 8-2008)

**Instructions for Schedule M—Bequests, etc., to Surviving Spouse (Marital Deduction)**

**General**

You must complete Schedule M and file it with the return if you claim a deduction on Part 5—Recapitulation, item 20.

The marital deduction is authorized by section 2056 for certain property interests that pass from the decedent to the surviving spouse. You may claim the deduction only for property interests that are included in the decedent’s gross estate (Schedules A through I).

**Note.** The marital deduction is generally not allowed if the surviving spouse is not a U.S. citizen. The marital deduction is allowed for property passing to such a surviving spouse in a *qualified domestic trust (QDOT)* or if such property is transferred or irrevocably assigned to such a trust before the estate tax return is filed. The executor must elect qualified domestic trust status on this return. See the instructions that follow, on pages 29 and 30, for details on the election.

**Property Interests That You May List on Schedule M**

Generally, you may list on Schedule M all property interests that pass from the decedent to the surviving spouse and are included in the gross estate. However, you should not list any *nondeductible terminable interests* (described below) on Schedule M unless you are making a QTIP election. The property for which you make this election must be included on Schedule M. See *Qualified terminable interest property* on the following page.

For the rules on common disaster and survival for a limited period, see section 2056(b)(3).

You may list on Schedule M only those interests that the surviving spouse takes:

1. As the decedent’s legatee, devisee, heir, or donee;
2. As the decedent’s surviving tenant by the entirety or joint tenant;
3. As an appointee under the decedent’s exercise of a power or as a taker in default at the decedent’s nonexercise of a power;
4. As a beneficiary of insurance on the decedent’s life;
5. As the surviving spouse taking under dower or curtesy (or similar statutory interest); and
6. As a transferee of a transfer made by the decedent at any time.

**Property Interests That You May Not List on Schedule M**

You should not list on Schedule M:

1. The value of any property that does not pass from the decedent to the surviving spouse;
2. Property interests that are not included in the decedent’s gross estate;

3. The full value of a property interest for which a deduction was claimed on Schedules J through L. The value of the property interest should be reduced by the deductions claimed with respect to it;

4. The full value of a property interest that passes to the surviving spouse subject to a mortgage or other encumbrance or an obligation of the surviving spouse. Include on Schedule M only the net value of the interest after reducing it by the amount of the mortgage or other debt;

5. Nondeductible terminable interests (described below); or

6. Any property interest disclaimed by the surviving spouse.

**Terminable Interests**

Certain interests in property passing from a decedent to a surviving spouse are referred to as “terminable interests.” These are interests that will terminate or fail after the passage of time, or on the occurrence or nonoccurrence of some contingency. Examples are: life estates, annuities, estates for terms of years, and patents.

The ownership of a bond, note, or other contractual obligation, which when discharged would not have the effect of an annuity for life or for a term, is not considered a terminable interest.

**Nondeductible terminable interests.** A terminable interest is nondeductible. Unless you are making a QTIP election, a terminable interest should not be entered on Schedule M if:

1. Another interest in the same property passed from the decedent to some other person for less than adequate and full consideration in money or money’s worth; and
2. By reason of its passing, the other person or that person’s heirs may enjoy part of the property after the termination of the surviving spouse’s interest.

This rule applies even though the interest that passes from the decedent to a person other than the surviving spouse is not included in the gross estate, and regardless of when the interest passes. The rule also applies regardless of whether the surviving spouse’s interest and the other person’s interest pass from the decedent at the same time.

Property interests that are considered to pass to a person other than the surviving spouse are any property interest that: (a) passes under a decedent’s will or intestacy; (b) was transferred by a decedent during life; or (c) is held by or passed on to any person as a decedent’s joint tenant, as appointee under a decedent’s exercise of a power, as taker in default at a decedent’s release or nonexercise of a power, or as a beneficiary of insurance on the decedent’s life.

For example, a decedent devised real property to his wife for life, with remainder to his children. The life interest that passed to the wife does not qualify for the marital deduction because it will terminate at her death and the children will thereafter possess or enjoy the property.

However, if the decedent purchased a joint and survivor annuity for himself and his wife who survived him, the value of the survivor’s annuity, to the extent that it is included in the gross estate, qualifies for the marital deduction because

**Examples of Listing of Property Interests on Schedule M**

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
<b>B1</b>	All other property: One-half the value of a house and lot, 256 South West Street, held by decedent and surviving spouse as joint tenants with right of survivorship under deed dated July 15, 1975 (Schedule E, Part I, item 1) . . . . .	\$182,500
<b>B2</b>	Proceeds of Metropolitan Life Insurance Company policy No. 104729, payable in one sum to surviving spouse (Schedule D, item 3) . . . . .	200,000
<b>B3</b>	Cash bequest under Paragraph Six of will . . . . .	100,000

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even though the interest will terminate on the wife's death, no one else will possess or enjoy any part of the property.

The marital deduction is not allowed for an interest that the decedent directed the executor or a trustee to convert, after death, into a terminable interest for the surviving spouse. The marital deduction is not allowed for such an interest even if there was no interest in the property passing to another person and even if the terminable interest would otherwise have been deductible under the exceptions described below for life estate and life insurance and annuity payments with powers of appointment. For more information, see Regulations sections 20.2056(b)-1(f) and 20.2056(b)-1(g), Example (7).

If any property interest passing from the decedent to the surviving spouse may be paid or otherwise satisfied out of any of a group of assets, the value of the property interest is, for the entry on Schedule M, reduced by the value of any asset or assets that, if passing from the decedent to the surviving spouse, would be nondeductible terminable interests. Examples of property interests that may be paid or otherwise satisfied out of any of a group of assets are a bequest of the residue of the decedent's estate, or of a share of the residue, and a cash legacy payable out of the general estate.

**Example.** A decedent bequeathed \$100,000 to the surviving spouse. The general estate includes a term for years (valued at \$10,000 in determining the value of the gross estate) in an office building, which interest was retained by the decedent under a deed of the building by gift to a son. Accordingly, the value of the specific bequest entered on Schedule M is \$90,000.

**Life estate with power of appointment in the surviving spouse.** A property interest, whether or not in trust, will be treated as passing to the surviving spouse, and will not be treated as a nondeductible terminable interest if: (a) the surviving spouse is entitled for life to all of the income from the entire interest; (b) the income is payable annually or at more frequent intervals; (c) the surviving spouse has the power, exercisable in favor of the surviving spouse or the estate of the surviving spouse, to appoint the entire interest; (d) the power is exercisable by the surviving spouse alone and (whether exercisable by will or during life) is exercisable by the surviving spouse in all events; and (e) no part of the entire interest is subject to a power in any other person to appoint any part to any person other than the surviving spouse (or the surviving spouse's legal representative or relative if the surviving spouse is disabled. See Rev. Rul. 85-35, 1985-1 C.B. 328). If these five conditions are satisfied only for a specific portion of the entire interest, see the section 2056(b) regulations to determine the amount of the marital deduction.

**Life insurance, endowment, or annuity payments, with power of appointment in surviving spouse.** A property interest consisting of the entire proceeds under a life insurance, endowment, or annuity contract is treated as passing from the decedent to the surviving spouse, and will not be treated as a nondeductible terminable interest if: (a) the surviving spouse is entitled to receive the proceeds in installments, or is entitled to interest on them, with all amounts payable during the life of the spouse, payable only to the surviving spouse; (b) the installment or interest payments are payable annually, or more frequently, beginning not later than 13 months after the decedent's death; (c) the surviving spouse has the power, exercisable in favor of the surviving spouse or of the estate of the surviving spouse, to appoint all amounts payable under the contract; (d) the power is exercisable by the surviving spouse alone and (whether exercisable by will or during life) is exercisable by the surviving spouse in all events; and (e) no part of the amount payable under the contract is subject to a power in

any other person to appoint any part to any person other than the surviving spouse. If these five conditions are satisfied only for a specific portion of the proceeds, see the section 2056(b) regulations to determine the amount of the marital deduction.

**Charitable remainder trusts.** An interest in a charitable remainder trust will not be treated as a nondeductible terminable interest if:

1. The interest in the trust passes from the decedent to the surviving spouse, and
2. The surviving spouse is the only beneficiary of the trust other than charitable organizations described in section 170(c).

A *charitable remainder trust* is either a charitable remainder annuity trust or a charitable remainder unitrust. (See section 664 for descriptions of these trusts.)

### Election To Deduct Qualified Terminable Interests (QTIP)

You may elect to claim a marital deduction for qualified terminable interest property or property interests. You make the QTIP election simply by listing the qualified terminable interest property on Schedule M and deducting its value. You are presumed to have made the QTIP election if you list the property and deduct its value on Schedule M. If you make this election, the surviving spouse's gross estate will include the value of the qualified terminable interest property. See the instructions for Part 4—General Information, line 6, for more details. **The election is irrevocable.**

If you file a Form 706 in which you do not make this election, you may not file an amended return to make the election unless you file the amended return on or before the due date for filing the original Form 706.

The effect of the election is that the property (interest) will be treated as passing to the surviving spouse and will not be treated as a nondeductible terminable interest. All of the other marital deduction requirements must still be satisfied before you may make this election. For example, you may not make this election for property or property interests that are not included in the decedent's gross estate.

**Qualified terminable interest property.** *Qualified terminable interest property* is property (a) that passes from the decedent, and (b) in which the surviving spouse has a qualifying income interest for life.

The surviving spouse has a *qualifying income interest for life* if the surviving spouse is entitled to all of the income from the property payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and during the surviving spouse's lifetime no person has a power to appoint any part of the property to any person other than the surviving spouse. An annuity is treated as an income interest regardless of whether the property from which the annuity is payable can be separately identified.

Amendments to Regulations sections 20.2044-1, 20.2056(b)-7, and 20.2056(b)-10 clarify that an interest in property is eligible for QTIP treatment if the income interest is contingent upon the executor's election even if that portion of the property for which no election is made will pass to or for the benefit of beneficiaries other than the surviving spouse.

The QTIP election may be made for all or any part of qualified terminable interest property. A partial election must relate to a fractional or percentile share of the property so that the elective part will reflect its proportionate share of the increase or decline in the whole of the property when applying section 2044 or 2519. Thus, if the interest of the surviving spouse in a trust (or other property in which the spouse has a qualified life estate) is qualified terminable

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interest property, you may make an election for a part of the trust (or other property) only if the election relates to a defined fraction or percentage of the entire trust (or other property). The fraction or percentage may be defined by means of a formula.

**Qualified Domestic Trust Election (QDOT)**

The marital deduction is allowed for transfers to a surviving spouse who is not a U.S. citizen only if the property passes to the surviving spouse in a qualified domestic trust (QDOT) or if such property is transferred or irrevocably assigned to a QDOT before the decedent's estate tax return is filed.

A QDOT is any trust:

1. That requires at least one trustee to be either an individual who is a citizen of the United States or a domestic corporation;
2. That requires that no distribution of corpus from the trust can be made unless such a trustee has the right to withhold from the distribution the tax imposed on the QDOT;
3. That meets the requirements of any applicable regulations; and
4. For which the executor has made an election on the estate tax return of the decedent.

**Note.** For trusts created by an instrument executed before November 5, 1990, paragraphs 1 and 2 above will be treated as met if the trust instrument requires that all trustees be individuals who are citizens of the United States or domestic corporations.

You make the QDOT election simply by listing the qualified domestic trust or the entire value of the trust property on Schedule M and deducting its value. You are presumed to have made the QDOT election if you list the trust or trust property and deduct its value on Schedule M. **Once made, the election is irrevocable.**

If an election is made to deduct qualified domestic trust property under section 2056A(d), provide the following information for each qualified domestic trust on an attachment to this schedule:

1. The name and address of every trustee;
2. A description of each transfer passing from the decedent that is the source of the property to be placed in trust; and
3. The employer identification number (EIN) for the trust.

The election must be made for an entire QDOT trust. In listing a trust for which you are making a QDOT election, unless you specifically identify the trust as not subject to the election, the election will be considered made for the entire trust.

The determination of whether a trust qualifies as a QDOT will be made as of the date the decedent's Form 706 is filed. If, however, judicial proceedings are brought before the Form 706's due date (including extensions) to have the trust revised to meet the QDOT requirements, then the determination will not be made until the court-ordered changes to the trust are made.

**Line 1**

If property passes to the surviving spouse as the result of a qualified disclaimer, check "Yes" and attach a copy of the written disclaimer required by section 2518(b).

**Line 3**

Section 2056(b)(7) creates an automatic QTIP election for certain joint and survivor annuities that are includible in the estate under section 2039. To qualify, only the surviving spouse can have the right to receive payments before the death of the surviving spouse.

The executor can elect out of QTIP treatment, however, by checking the "Yes" box on line 3. **Once made, the election is irrevocable.** If there is more than one such joint and survivor annuity, you are not required to make the election for all of them.

If you make the election out of QTIP treatment by checking "Yes" on line 3, you cannot deduct the amount of the annuity on Schedule M. If you do not make the election out, you must list the joint and survivor annuities on Schedule M.

**Listing Property Interests on Schedule M**

List each property interest included in the gross estate that passes from the decedent to the surviving spouse and for which a marital deduction is claimed. This includes otherwise nondeductible terminable interest property for which you are making a QTIP election. Number each item in sequence and describe each item in detail. Describe the instrument (including any clause or paragraph number) or provision of law under which each item passed to the surviving spouse. If possible, show where each item appears (number and schedule) on Schedules A through I.

In listing otherwise nondeductible property for which you are making a QTIP election, unless you specifically identify a fractional portion of the trust or other property as not subject to the election, the election will be considered made for all of the trust or other property.

Enter the value of each interest before taking into account the federal estate tax or any other death tax. The valuation dates used in determining the value of the gross estate apply also on Schedule M.

If Schedule M includes a bequest of the residue or a part of the residue of the decedent's estate, attach a copy of the computation showing how the value of the residue was determined. Include a statement showing:

- The value of all property that is included in the decedent's gross estate (Schedules A through I) but is not a part of the decedent's probate estate, such as lifetime transfers, jointly owned property that passed to the survivor on decedent's death, and the insurance payable to specific beneficiaries;
- The values of all specific and general legacies or devises, with reference to the applicable clause or paragraph of the decedent's will or codicil. (If legacies are made to each member of a class; for example, \$1,000 to each of decedent's employees, only the number in each class and the total value of property received by them need be furnished);
- The date of birth of all persons, the length of whose lives may affect the value of the residuary interest passing to the surviving spouse; and
- Any other important information such as that relating to any claim to any part of the estate not arising under the will.

**Lines 5a, 5b, and 5c.** The total of the values listed on Schedule M must be reduced by the amount of the federal estate tax, the federal GST tax, and the amount of state or other death and GST taxes paid out of the property interest involved. If you enter an amount for state or other death or GST taxes on line 5b or 5c, identify the taxes and attach your computation of them.

**Attachments.** If you list property interests passing by the decedent's will on Schedule M, attach a certified copy of the order admitting the will to probate. If, when you file the return, the court of probate jurisdiction has entered any decree interpreting the will or any of its provisions affecting any of the interests listed on Schedule M, or has entered any order of distribution, attach a copy of the decree or order. In addition, the IRS may request other evidence to support the marital deduction claimed.

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**SCHEDULE O—Charitable, Public, and Similar Gifts and Bequests**

	Yes	No
<b>1a</b> If the transfer was made by will, has any action been instituted to have interpreted or to contest the will or any of its provisions affecting the charitable deductions claimed in this schedule? . . . . . If "Yes," full details must be submitted with this schedule.	<input type="checkbox"/>	<input type="checkbox"/>
<b>b</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.	<input type="checkbox"/>	<input type="checkbox"/>
<b>2</b> 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).	<input type="checkbox"/>	<input type="checkbox"/>

Item number	Name and address of beneficiary	Character of institution	Amount
1			

Total from continuation schedules (or additional sheets) attached to this schedule . . . . .

<b>3</b> Total . . . . .			<b>3</b>
<b>4a</b> Federal estate tax payable out of property interests listed above . . . . .	<b>4a</b>		
<b>b</b> Other death taxes payable out of property interests listed above . . . . .	<b>4b</b>		
<b>c</b> Federal and state GST taxes payable out of property interests listed above . . . . .	<b>4c</b>		
<b>d</b> Add items 4a, 4b, and 4c . . . . .			<b>4d</b>
<b>5</b> Net value of property interests listed above (subtract 4d from 3). Also enter on Part 5—Recapitulation, page 3, at item 21 . . . . .			<b>5</b>

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(The instructions to Schedule O are in the separate instructions.)

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Estate of:

**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

*(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)	<b>1</b>	
2 Value of the gross estate (adjusted, if necessary, according to the instructions for item 2)	<b>2</b>	
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 for item 3)	<b>3</b>	
4 Tax imposed by section 2001 reduced by the total credits claimed under sections 2010 and 2012 (see instructions)	<b>4</b>	
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.)	<b>5</b>	
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	<b>6</b>	

**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
<b>A</b>				
<b>B</b>				
<b>C</b>				

Check here  if section 2013(f) (special valuation of farm, etc., real property) adjustments to the computation of the credit were made (see page 23 of the instructions).

**Part 2. Computation of Credit** (see instructions on page 23)

Item	Transferor			Total A, B, & C
	A	B	C	
1 Transferee's tax as apportioned (from worksheet, (line 7 ÷ line 8) x 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 x 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				



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**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 the separate instructions beginning on page 23)

**Part 1. GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) (Special QTIP) Election**

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 page 26 of the separate instructions for details.

<b>1</b> Maximum allowable GST exemption . . . . .	<b>1</b>
<b>2</b> Total GST exemption allocated by the decedent against decedent's lifetime transfers . . . . .	<b>2</b>
<b>3</b> Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers . . . . .	<b>3</b>
<b>4</b> GST exemption allocated on line 6 of Schedule R, Part 2 . . . . .	<b>4</b>
<b>5</b> GST exemption allocated on line 6 of Schedule R, Part 3 . . . . .	<b>5</b>
<b>6</b> Total GST exemption allocated on line 4 of Schedule(s) R-1 . . . . .	<b>6</b>
<b>7</b> Total GST exemption allocated to <i>inter vivos</i> transfers and direct skips (add lines 2–6) . . . . .	<b>7</b>
<b>8</b> GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1) . . . . .	<b>8</b>

**9** Allocation of GST exemption to trusts (as defined for GST tax purposes):

<b>A</b> Name of trust	<b>B</b> Trust's EIN (if any)	<b>C</b> GST exemption allocated on lines 2–6, above (see instructions)	<b>D</b> Additional GST exemption allocated (see instructions)	<b>E</b> 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 schedule (see instructions). **10**

(The instructions to Schedule R are in the separate instructions.)



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**Part 2. Direct Skips Where the Property Interests Transferred Bear the GST Tax on the Direct Skips**

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 3.222222). . . . .	8	
9 Enter the amount from line 8 of Schedule R, Part 3 . . . . .	9	
<b>10 Total GST taxes payable by the estate</b> (add lines 8 and 9). Enter here and on line 17 of Part 2—Tax Computation, on page 1. . . . .	<b>10</b>	

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<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : :
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**Part 3. Direct Skips Where the Property Interests Transferred Do Not Bear the GST Tax on the Direct Skips**

Name of skip person	Description of property interest transferred	Estate tax value

1 Total estate tax values of all property interests listed above . . . . .	<b>1</b>	
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above . . . . .	<b>2</b>	
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) . . . . .	<b>3</b>	
4 Total fixed taxes and other charges (add lines 2 and 3). . . . .	<b>4</b>	
5 Total tentative maximum direct skips (subtract line 4 from line 1) . . . . .	<b>5</b>	
6 GST exemption allocated . . . . .	<b>6</b>	
7 Subtract line 6 from line 5 . . . . .	<b>7</b>	
8 GST tax due (multiply line 7 by .45). Enter here and on Schedule R, Part 2, line 9 . . . . .	<b>8</b>	



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## 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 2 copies. File one copy and keep one for your records.

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**How to pay** You can pay by check or money order.

- Make it payable to the “United States Treasury.”
- Make the check or money order for the amount on line 6 of Schedule R-1.
- Write “GST Tax” and the trust’s EIN on the check or money order.

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**Signature** You must sign the Schedule R-1 in the space provided.

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**What to mail** Mail your check or money order and the copy of Schedule R-1 that you signed.

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**Where to mail** Mail to the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999.

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**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.

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**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).

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**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.

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Estate of:

**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 separate 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 separate instructions). \_\_\_\_\_

**Part 3. Computation of Exclusion**

4	Estate tax value of the land subject to the qualified conservation easement (see separate 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) . . . . . <b>Note.</b> 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.	10					
11	Divide line 10 by line 8. Figure to 3 decimal places (for example, ".123") . . . . . <b>Note.</b> If line 11 is equal to or less than .100, stop here; the estate does not qualify for the conservation easement exclusion.	11					
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 separate instructions) . . . . .	15					
16	Amount of indebtedness on the land (see separate 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 11, Part 5—Recapitulation, page 3 . . . . .	20					

Form 706 (Rev. 8-2008)

(Make copies of this schedule before completing it if you will need more than one schedule.)

<b>Estate of:</b>	<b>Decedent's Social Security Number</b> : : : :
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**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
<b>TOTAL.</b> (Carry forward to main schedule.) . . . . .					

See the instructions on the reverse side.



Form 706 (Rev. 8-2008)

## Instructions for Continuation Schedule

When you need to list more assets or deductions than you have room for on one of the main schedules, use the Continuation Schedule on page 39. It provides a uniform format for listing additional assets from Schedules A through I and additional deductions from Schedules J, K, L, M, and O.

Please keep the following points in mind:

- Use a separate Continuation Schedule for each main schedule you are continuing. Do not combine assets or deductions from different schedules on one Continuation Schedule.
- Make copies of the blank schedule before completing it if you expect to need more than one.
- Use as many Continuation Schedules as needed to list all the assets or deductions.
- Enter the letter of the schedule you are continuing in the space at the top of the Continuation Schedule.
- Use the *Unit value* column **only** if continuing Schedule B, E, or G. For all other schedules, use this space to continue the description.
- Carry the total from the Continuation Schedules forward to the appropriate line on the main schedule.

<b>If continuing</b>	<b>Report</b>	<b>Where on Continuation Schedule</b>
Schedule E, Pt. 2	<i>Percentage includible</i>	<i>Alternate valuation date</i>
Schedule K	<i>Amount unpaid to date</i>	<i>Alternate valuation date</i>
Schedule K	<i>Amount in contest</i>	<i>Alternate value</i>
Schedules J, L, M	<i>Description of deduction continuation</i>	<i>Alternate valuation date and Alternate value</i>
Schedule O	<i>Character of institution</i>	<i>Alternate valuation date and Alternate value</i>
Schedule O	<i>Amount of each deduction</i>	<i>Amount deductible</i>

**Appendix IV**

**IRS Form 709—United States Gift (and Generation-Skipping Transfer) Tax Return, 2008**



Form **709**  
 Department of the Treasury  
 Internal Revenue Service

**United States Gift (and Generation-Skipping Transfer) Tax Return**  
 (For gifts made during calendar year 2008)

OMB No. 1545-0020  
**2008**

▶ See separate instructions.

**Part 1 — General Information**

<b>1</b> Donor's first name and middle initial	<b>2</b> Donor's last name	<b>3</b> Donor's social security number
<b>4</b> Address (number, street, and apartment number)		<b>5</b> Legal residence (domicile)
<b>6</b> City, state, and ZIP code		<b>7</b> Citizenship (see instructions)
<b>8</b> If the donor died during the year, check here <input type="checkbox"/> and enter date of death .....		<b>Yes</b> <b>No</b>
<b>9</b> If you extended the time to file this Form 709, check here <input type="checkbox"/>		
<b>10</b> Enter the total number of donees listed on Schedule A. Count each person only once. ▶		
<b>11a</b> Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b . . . . .		
<b>b</b> If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)? . . . . .		
<b>12</b> <b>Gifts by husband or wife to third parties.</b> Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. <b>If the answer is "No," skip lines 13–18 and go to Schedule A.</b> ) . . . . .		
<b>13</b> Name of consenting spouse	<b>14</b> SSN	
<b>15</b> Were you married to one another during the entire calendar year? (see instructions) . . . . .		
<b>16</b> If 15 is "No," check whether <input type="checkbox"/> married <input type="checkbox"/> divorced or <input type="checkbox"/> widowed/deceased, and give date (see instructions) ▶		
<b>17</b> Will a gift tax return for this year be filed by your spouse? (If "Yes," mail both returns in the same envelope.) . . . . .		
<b>18</b> <b>Consent of Spouse.</b> I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		

<b>Consenting spouse's signature ▶</b>		<b>Date ▶</b>	
<b>1</b> Enter the amount from Schedule A, Part 4, line 11 . . . . .	<b>1</b>		
<b>2</b> Enter the amount from Schedule B, line 3 . . . . .	<b>2</b>		
<b>3</b> Total taxable gifts. Add lines 1 and 2 . . . . .	<b>3</b>		
<b>4</b> Tax computed on amount on line 3 (see <i>Table for Computing Gift Tax</i> in separate instructions) . . . . .	<b>4</b>		
<b>5</b> Tax computed on amount on line 2 (see <i>Table for Computing Gift Tax</i> in separate instructions) . . . . .	<b>5</b>		
<b>6</b> Balance. Subtract line 5 from line 4 . . . . .	<b>6</b>		
<b>7</b> Maximum unified credit (nonresident aliens, see instructions) . . . . .	<b>7</b>	345,800	00
<b>8</b> Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C) . . . . .	<b>8</b>		
<b>9</b> Balance. Subtract line 8 from line 7 . . . . .	<b>9</b>		
<b>10</b> Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions) . . . . .	<b>10</b>		
<b>11</b> Balance. Subtract line 10 from line 9 . . . . .	<b>11</b>		
<b>12</b> Unified credit. Enter the smaller of line 6 or line 11 . . . . .	<b>12</b>		
<b>13</b> Credit for foreign gift taxes (see instructions) . . . . .	<b>13</b>		
<b>14</b> Total credits. Add lines 12 and 13 . . . . .	<b>14</b>		
<b>15</b> Balance. Subtract line 14 from line 6. Do not enter less than zero . . . . .	<b>15</b>		
<b>16</b> Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, Total) . . . . .	<b>16</b>		
<b>17</b> Total tax. Add lines 15 and 16 . . . . .	<b>17</b>		
<b>18</b> Gift and generation-skipping transfer taxes prepaid with extension of time to file . . . . .	<b>18</b>		
<b>19</b> If line 18 is less than line 17, enter <b>balance due</b> (see instructions) . . . . .	<b>19</b>		
<b>20</b> If line 18 is greater than line 17, enter <b>amount to be refunded</b> . . . . .	<b>20</b>		

<b>Attach check or money order here.</b>	<b>Sign Here</b>	Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.	
		Signature of donor	Date
<b>Paid Preparer's Use Only</b>	Preparer's signature ▶	Date	Check if self-employed <input type="checkbox"/>
	Firm's name (or yours if self-employed), address, and ZIP code ▶	EIN ;	Preparer's SSN or PTIN
		Phone no. ( )	

May the IRS discuss this return with the preparer shown below (see instructions)?  Yes  No

**SCHEDULE A Computation of Taxable Gifts (Including transfers in trust) (see instructions)**

**A** Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . . Yes  No

**B**  Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

**Part 1—Gifts Subject Only to Gift Tax.** Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item number	B <ul style="list-style-type: none"> <li>• Donee's name and address</li> <li>• Relationship to donor (if any)</li> <li>• Description of gift</li> <li>• If the gift was of securities, give CUSIP no.</li> <li>• If closely held entity, give EIN</li> </ul>	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter ½ of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse—complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

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**Total of Part 1.** Add amounts from Part 1, column H . . . . . ▶

**Part 2—Direct Skips.** Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B <ul style="list-style-type: none"> <li>• Donee's name and address</li> <li>• Relationship to donor (if any)</li> <li>• Description of gift</li> <li>• If the gift was of securities, give CUSIP no.</li> <li>• If closely held entity, give EIN</li> </ul>	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter ½ of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse—complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

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**Total of Part 2.** Add amounts from Part 2, column H . . . . . ▶

**Part 3—Indirect Skips.** Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B <ul style="list-style-type: none"> <li>• Donee's name and address</li> <li>• Relationship to donor (if any)</li> <li>• Description of gift</li> <li>• If the gift was of securities, give CUSIP no.</li> <li>• If closely held entity, give EIN</li> </ul>	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter ½ of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse—complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

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**Total of Part 3.** Add amounts from Part 3, column H . . . . . ▶

(If more space is needed, attach additional sheets of same size.)

**Part 4—Taxable Gift Reconciliation**

<b>1</b>	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3 . . . . .	<b>1</b>		
<b>2</b>	Total annual exclusions for gifts listed on line 1 (see instructions) . . . . .	<b>2</b>		
<b>3</b>	Total included amount of gifts. Subtract line 2 from line 1 . . . . .	<b>3</b>		
<b>Deductions</b> (see instructions)				
<b>4</b>	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers . . . . . of Schedule A . . . . .	<b>4</b>		
<b>5</b>	Exclusions attributable to gifts on line 4 . . . . .	<b>5</b>		
<b>6</b>	Marital deduction. Subtract line 5 from line 4 . . . . .	<b>6</b>		
<b>7</b>	Charitable deduction, based on item nos. . . . . less exclusions . . . . .	<b>7</b>		
<b>8</b>	Total deductions. Add lines 6 and 7 . . . . .	<b>8</b>		
<b>9</b>	Subtract line 8 from line 3 . . . . .	<b>9</b>		
<b>10</b>	Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)	<b>10</b>		
<b>11</b>	<b>Taxable gifts.</b> Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1 . . . . .	<b>11</b>		

**Terminable Interest (QTIP) Marital Deduction.** (See instructions for Schedule A, Part 4, line 4.)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and:

- a. The trust (or other property) is listed on Schedule A, and
- b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule A, Part 4, line 4,

then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Parts 1 and 3 of Schedule A is entered as a deduction on line 4, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule A, Part 4, line 6. The denominator is equal to the total value of the trust (or other property) listed in Parts 1 and 3 of Schedule A.

If you make the QTIP election, the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). See instructions for line 4 of Schedule A. If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax. See *Transfer of Certain Life Estates Received From Spouse* on page 4 of the instructions.

**12 Election Out of QTIP Treatment of Annuities**

◀ Check here if you elect under section 2523(f)(6) **not** to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). See instructions. Enter the item numbers from Schedule A for the annuities for which you are making this election ▶ .....

**SCHEDULE B Gifts From Prior Periods**

If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C, if applicable).

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of unified credit against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts
<b>1</b>	Totals for prior periods . . . . .	<b>1</b>		
<b>2</b>	Amount, if any, by which total specific exemption, line 1, column D, is more than \$30,000 . . . . .		<b>2</b>	
<b>3</b>	Total amount of taxable gifts for prior periods. Add amount on line 1, column E and amount, if any, on line 2. Enter here and on page 1, Part 2—Tax Computation, line 2 . . . . .		<b>3</b>	

(If more space is needed, attach additional sheets of same size.)









**Siegel, William C.; Haney, Harry L., Jr.; Greene, John L.** 2009. Estate planning for forest landowners: what will become of your timber? Gen. Tech. Rep. SRS-112. Asheville, NC: U.S. Department of Agriculture Forest Service, Southern Research Station. 180 p.

The purpose of this book is to provide guidelines and assistance to nonindustrial private forest owners and the legal, tax, financial, insurance, and forestry professionals who serve them on the application of estate planning techniques to forest properties. The book presents a working knowledge of the Federal estate and gift tax law as of September 30, 2008, with particular focus on the unique characteristics of owning timber and forest land. It consists of four major parts, plus appendices. Part I develops the practical and legal foundation for estate planning. Part II explains and illustrates the use of general estate planning tools. Part III explains and illustrates the use of additional tools that are specific to forest ownership. Part IV describes the forms of forest land ownership, as well as the basic features of State transfer taxes and the benefits of forest estate planning. The appendices include a glossary and the Federal forms for filing estate and gift taxes.

**Keywords:** Estate planning, estate tax, gift tax, insurance, special use valuation, transfer tax, trust.



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