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# Estate Planning for Forest Landowners

## What will Become of Your Timberland?

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



## **Summary**

This book's purpose is to provide guidelines and assistance to nonindustrial private woodland owners in applying estate planning techniques to their forest properties. It presents a working knowledge of the Federal estate and gift tax law as it relates to timberland ownership. The unique character of timber assets is addressed in terms of tree farm estate planning goals. The book has four major parts plus a glossary, selected tax forms, and a list of additional readings. The foundation for estate planning is developed in part I. The general estate planning tools are explained in part II and integrated with forestry examples. Part III is concerned with forestry-specific estate planning tools. The various forms of timberland ownership and their relationship to forestry estate planning, as well as the basic features of State death taxes, are discussed in part IV.

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**Estate Planning**

**For**

**Forest Landowners**

**What Will Become of Your Timberland?**

**Harry L. Haney, Jr., and William C. Siegel**

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## **PART I**

### **INTRODUCTION**



# Chapter 1

## The Importance of Forestry Estate Planning

### FOREST OWNERSHIP

Forests comprise one-third of the Nation's land. Almost three-fourths of this woodland--about 350 million acres--is privately owned. Most of the private holdings, some 283 million acres, belong to nonindustrial owners. A nonindustrial private owner is one who does not have a primary wood-processing plant, that is, an owner who is not classified as a forest industry. Nonindustrial private owners control 60 percent of the total commercial forest lands in the United States.

#### A Diverse Group

There are nearly 8 million nonindustrial private forest landowners. More than 6 million hold their forest properties either as sole proprietors or in nonformal family ownerships. These two categories account for 55 percent of the nation's private woodland acreage. The remainder of the nonindustrial forest is owned by family corporations, family partnerships, or various other types of ownership entities. The typical nonindustrial owner is over 50 years old. Nearly one in five is retired. Almost half of the private forests in the United States are in ownerships of more than 500 acres, with an additional 31 percent in ownerships of 100 to 500 acres.

Forest land and timber values have been rising rapidly in many parts of the country in recent years. Often market values reflect factors other than commercial timber production. At the present time, normal estate valuation rules pose a real danger for many estates with substantial woodland holdings. Without proper estate planning, forced liquidation of family forests or severe disruption of management regimes is a distinct possibility.

#### What Can Happen?

Have you thought of retiring soon to try the projects that you have always wanted to do on your tree farm while you still have good health and energy? Are the thinnings, timber stand improvements, hiking trails, and the cabin by the creek still feasible? But, can you afford to retire and still enjoy a satisfactory lifestyle? Are the children educated

and independent? How will the retirement affect your timber investments?

Going one step further, if you die today, what will happen to the timberland that you and your spouse perhaps have worked a lifetime for? Will your forest management program be disrupted in order to adequately provide for your spouse and children in an equitable manner? Will the woodland continue to function efficiently and will your spouse have adequate control? Are your forestry investments structured so that they will not lose value at your death? Will the timber management plan continue to function as an effective tool for your spouse to follow? Have steps been taken to minimize death taxes, or will timber or land or both have to be sold to pay debts?

Examples abound of forested estates that were profitable during the decedent's lifetime, but had to be partially or entirely liquidated to settle estate debts and pay death taxes. Also, in unplanned situations, the heirs may quarrel over the settlement of the estate and dissipate valuable forest resources.

### BOOK POLICY

#### Purpose

This book has been written to assist nonindustrial private landowners in addressing the considerations enumerated above. It is designed to provide a working knowledge of the Federal estate and gift tax law as it relates to estate planning for timberland owners. The unique character of timber assets is addressed in terms of the estate planning goals of a woodland owner. The purpose is to enhance, not replace, communication with estate planning advisors, and to make estate planning more efficient through understanding the process as an informed timberland owner. In all cases, well-qualified professional advisors are essential.

#### Educational, Not Legal, Advice

The discussion and examples presented here should be regarded as educational, not legal, advice. The facts and circumstances of one's personal situation--goals, financial portfolio, land and timber inventory,

and special considerations--should be carefully reviewed with an attorney and estate planning advisor. The applicable laws and regulations, which are often both complex and dynamic, must be applied in the context of a specific situation and economic circumstances before making legal and financial decisions. The book is written within the framework of Federal law, but an understanding of the applicable State law that affects the ownership, management, and transfer of timberland assets should also be incorporated into estate planning deliberations. Because State law varies widely among the 50 States, much of it is beyond the scope of this publication.

## Structure

This book has four major parts plus an appendix with a glossary, selected Internal Revenue Service (IRS) tables, selected tax forms, and a list of selected additional readings on estate planning. The foundation for estate planning is developed in part I. Estate planning considerations and objectives, the planning process, and valuation principles are discussed. In addition, the Federal estate and gift tax process, and the legal basis for estate planning, are addressed.

The general estate **planning** tools are explained in part II and integrated with forestry examples. These include use of the marital deduction, disclaimers, and strategies for gifting forestry assets. The role of trusts, life insurance, and installment contracts in estate planning are also discussed.

Part III is concerned with forestry-specific estate planning tools. The planning and requirements necessary to qualify for and effectively utilize special

use valuation, and the deferral and extension of Federal estate tax provisions is covered in detail.

The various forms of timberland ownership and their relationship to forestry estate planning are discussed in part IV. Alternative business structures for timber estates, including the advantages and disadvantages of each, are also addressed.

In part IV, chapter 19, State death taxes are treated. The basic features of the statutes in each State are discussed.

Forestry examples are used throughout the text to explain the use of various estate planning tools. The case examples draw from several regions of the United States and incorporate combinations of strategies from which to choose, depending on particular goals.

## READINESS QUESTIONNAIRE.

As indicated above, effective estate planning is an ongoing process consisting of three major components. The first concerns effective management of the estate assets during the decedent'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 decedent's wishes, with a minimum of problems and with minimum tax liability. The third encompasses **nontax** situations that only the decedent can address during his (her) lifetime through personal understanding of family circumstances and their interaction with effective planning. At this time, 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 the estimated Federal and State death taxes, as <b>well</b> 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 with my spouse a plan for continued management of the family's timberland.
___	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.
___	8. I am aware of the tax savings available by using the <b>gift</b> provisions of the tax law.
	9. I understand the importance of <b>life</b> insurance in my estate planning.
	10. I am aware of my spouse's life insurance policies and 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 disadvantages of each.
	12. I know how much family income <b>will</b> be received from retirement plans, social security, annuities, and <b>other</b> sources.
	13. Both my spouse and I know how to contact our attorney, accountant, banking officer, and <b>life</b> insurance agent. We <b>both</b> know where important documents are stored.

Figure 1.1 --Estate Planning Readiness Questionnaire.



## Chapter 2

### Estate Planning Considerations and Objectives

#### THE HIGH COST OF DYING UNPREPARED

Do you have an estate plan? The answer is “yes”! Even if a person has not expressed his (her) desires by writing a will, the State in which a person is legally domiciled has a plan for disposing of his (her) property. In fact, all States have laws of descent and distribution. If an individual has not exercised the right to specify who will receive his (her) 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 upon because there are a number of considerations that State law does not address. Simply stated, the rules are specific as to who gets the residue of the estate after the “transfer costs” have been paid.

#### Unexpected Heirs

When a person dies intestate (without a will), the State laws of descent and distribution determine what happens to his (her) property. The surviving spouse, children, parents, brothers and sisters, and other relatives are considered in more or less that general order. State law does vary in this regard, however, and becomes more complicated where second and third marriages are involved--especially when there are minor children. State statutes rarely consider the needs of the heirs, their contributions to the estate, or the tax consequences of the distribution.

#### Unexpected Values

The fair market value (FMV) of appreciated real estate, closely held stock, jointly held property, and other low current return interests may greatly exceed the value attributable to such property from current cash flows. Fair market value also exceeds valuations based on the use value of the assets (discussed in chapter 13). The Internal Revenue Service (IRS) focuses estimates of value on the “highest and best use” of the property, preferring market transactions

evidence of value wherever possible. Therefore, IRS valuations may be much higher than the values ascribed to estate assets by the executor.

#### Transfer Costs

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

**Federal and State Death Taxes.--**The Federal death tax law encompasses a unified transfer tax on taxable lifetime gifts, combined with property passing at death, in calculating tax liability. The gift and estate tax rates effectively begin at 37 percent on taxable values in excess of the \$600,000 exemption equivalent. They increase progressively to 55 percent on amounts over \$3 million (the Federal estate and gift tax process is discussed in more detail in chapter 3). Many States have an estate or inheritance tax law that imposes additional death taxes. These can amount to as much as 20 percent of the Federal tax cost. Other States have adopted what is commonly called a “pick-up tax,” which makes the State tax equal to the credit for State death taxes allowed on the Federal estate tax return. In this case, no additional tax is owed; thus, it is important to know State law for planning purposes. State death taxes are discussed more completely in chapter 19.

**Probate and Administration Expenses.--**The cost of probate (see chapter 5) and estate administration expenses comprise the other so-called “transfer costs.” At least some States have statutory limits for probate costs that are associated with small estates. Thresholds for the applicable amounts under small estate laws vary from approximately \$5,000 to \$100,000. On estates exceeding the threshold, probate expenses may amount to as much as 8 to 9 percent of the gross value of the estate. Generally, these costs gradually fall to approximately 5 percent of the gross estate value as estate size increases to \$1 million. Wide variations within these parameters are possible, however, depending on State law and the complexity of the estate. On larger estates, the charges should drop even more as a percentage of value if no undue problems are encountered. Administration and related costs incurred by the executor will be in addition to the cost of probate. Of course, major problems can

sharply escalate legal costs—for example, a legal challenge to the will.

On a \$1,000,000 taxable estate (gross estate minus all permitted deductions as explained on page 21) the total average settlement costs (Federal estate tax plus administration expenses equal to 5 percent of the estate) would be \$203,000 (see table 2.1). This amount increases to \$688,000 on a taxable estate of \$2,000,000. Note that on a \$10 million estate the total transfer cost has risen to over 54 percent of the taxable value. State death taxes are not included in these estimates.

### **Loss of Leadership and Income**

The owner's leadership and skill may be indispensable in successfully managing the timber property. Knowing boundary locations; having good relationships with neighbors, consultant foresters, loggers, and reforestation contractors; having an understanding of silviculture; and having timber marketing experience are all part of a knowledge base often built up over a long period of time. This experience may be difficult or impossible to replace in the short run. At the owner's death this leadership will be lost.

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

### **Shrinkage Because of Liquidation**

When business assets have to be sold to pay taxes and administration expenses or to retire indebtedness, shrinkage losses can often amount to 40 percent or more 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 the resources of an estate among the heirs may also have unfavorable consequences both in terms of valuation and management.

### **Ancillary Probate**

Ancillary probate proceedings are generally required when real property is held in more than one State. The additional legal costs increase the estate's overall administrative expenses.

## **ESTATE PLANNING CONSIDERATIONS PECULIAR TO FORESTRY**

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

### **Illiquidity of Land and Timber Assets**

Land "dedicated" to timber production is characterized by a very long investment horizon. Timely and appropriate management decisions are important in order to establish and maintain the necessary level of timber growing stock to match earning potential. This importance is illustrated in the value growth curves for loblolly pine shown in figure 2.1. Here land has a constant price of \$300 per acre with no inflation or real price appreciation. Timber value growth is based on site 60 yields (base age 25) without thinning. Site 60 is an average site for much of the south. Stumpage prices are constant and are shown at three levels—high, medium and low—taken from Timber-Mart South.<sup>7</sup> Note that timber income becomes possible only after age 15. Values then increase rapidly until approximately age 30, but thereafter increase at a declining rate.

The effects of the price level are shown by the three curves and illustrate the importance of developing strategies that make it possible to obtain the higher price. Because value is a function of price and volume, these curves serve as a proxy for both site quality and stocking level. As stocking levels fall, the value growth curve will shift downward reflecting the reduced potential of forestry's financial returns over time as a result of inadequate investment in growing stock. Similarly, poor land will result in lower position curves that reflect the reduced production potential. Thus, combinations of low price, poor stocking, and/or poor site serve to reduce the responsiveness

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<sup>7</sup>Timber-Mart South is a timber price reporting service for the Southern States that is published quarterly by Timber-Mart South, Inc., P.O. 1278, Highlands, NC 28741.



Table 2.1.-- *The high cost of dying--average settlement costs at death based on Federal estate tax after 1992, plus an average administration cost of 5 percent.*

Taxable estate	Federal estate tax	Administration expense	Total settlement cost
<hr/> -----Dollars-----			
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	37,000	35,000	72,000
800,000	75,000	40,000	115,000
900,000	114,000	45,000	159,000
1,000,000	153,000	50,000	203,000
1,250,000	255,500	62,500	318,000
1,500,000	363,000	75,000	438,000
1,750,000	475,500	87,500	563,000
2,000,000	588,000	100,000	688,000
2,250,000	710,500	112,500	823,000
2,500,000	833,000	125,000	958,000
3,000,000	1,098,000	150,000	1,248,000
3,500,000	1,373,000	175,000	1,548,000
4,000,000	1,648,000	200,000	1,848,000
5,000,000	2,198,000	250,000	2,448,000
6,000,000	2,748,000	300,000	3,048,000
7,000,000	3,298,000	350,000	3,648,000
8,000,000	3,848,000	400,000	4,248,000
9,000,000	4,398,000	450,000	4,848,000
10,000,000	4,948,000	500,000	5,448,000

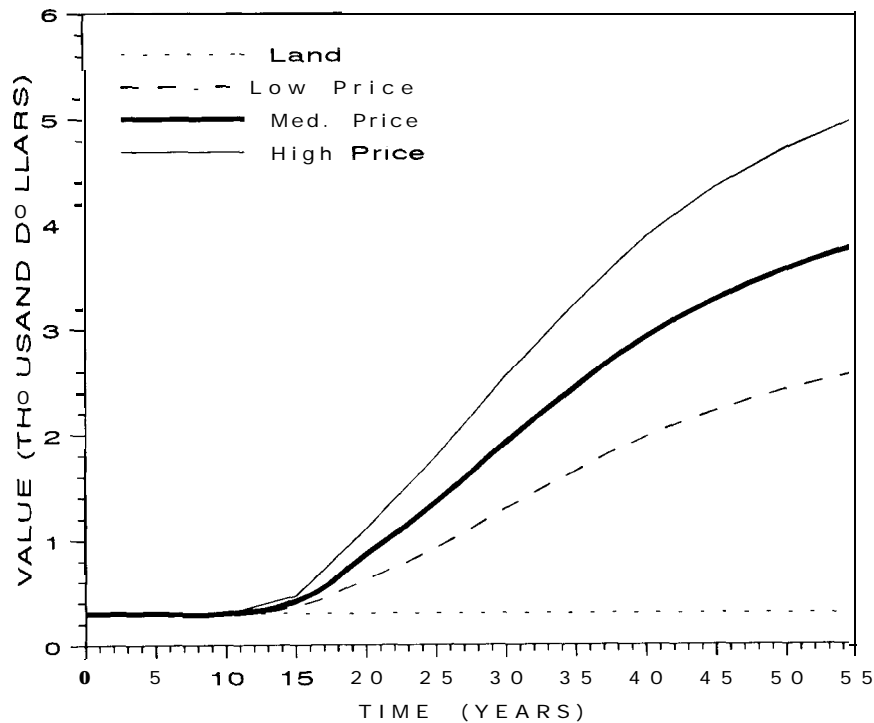


Figure 2.1.-- Land and timber values per acre for *loblolly* pine plantations at constant prices on site 60, base age 25 (average site for the South). Timber value equals volume (yield) times price.

of timber investments by lowering revenues and lengthening the rotation, which in turn increases illiquidity.

Uncertainty caused by long time horizons limits the potential number of buyers in the market for timber property. Consequently, marketing skills, timing, and luck are usually all necessary in order to obtain top prices when selling timberland. As tract size and value increase, the number of potential buyers may be further restricted simply by the financial limitations.

The example just discussed is for southern pine timberland. However, the basic principles that are illustrated should apply for most species in most parts of the United States.

While the biological process of stand value growth is regular and predictable, timber stumpage prices behave in a much less predictable fashion, sometimes with wide fluctuations over relatively short periods of time. Volatile prices often follow sharp, irregular price cycles (see fig. 2.2). For example, the average price of Douglas-fir rose from \$169.50 per thousand board feet (MBF) in 1975 to \$432.20 per MBF in 1980--an increase of 155 percent in 5 years. It then dropped precipitously by 73 percent to \$118.20 per MBF in 1982. Six years later, in 1988, the price had

risen to \$256.00 per MBF. As further evidence of price volatility, the stumpage price of export grade Douglas-fir was approximately \$700 per MBF during the summer of 1992, and some observers predict a price of \$1,000 per MBF by 1994 because of court-mandated withdrawals from the timber supply base in spotted owl habitats.

In other regions, stumpage price fluctuations have been less dramatic but, nevertheless, important to landowner marketing strategies. In the South, for example, southern pine prices increased gradually from \$57 per MBF in 1975 to \$172 in 1981--an increase of 202 percent over 6 years. In 1982, the price dropped to \$127.00 per MBF and ultimately to \$90.70 by 1985--a decline of 47 percent in 4 years. By 1993, prices in many parts of the South had increased dramatically to between \$250 and \$300 per MBF. Of course, changes such as these do not matter unless timber is actually sold when prices are high. Generally, however, volume and quality will continue to increase throughout the investment period.

The cost of capital, or the interest rate, is a critical input because forestry is a capital intensive investment. Land committed to growing trees has an "opportunity cost," because it could be sold and the income invested

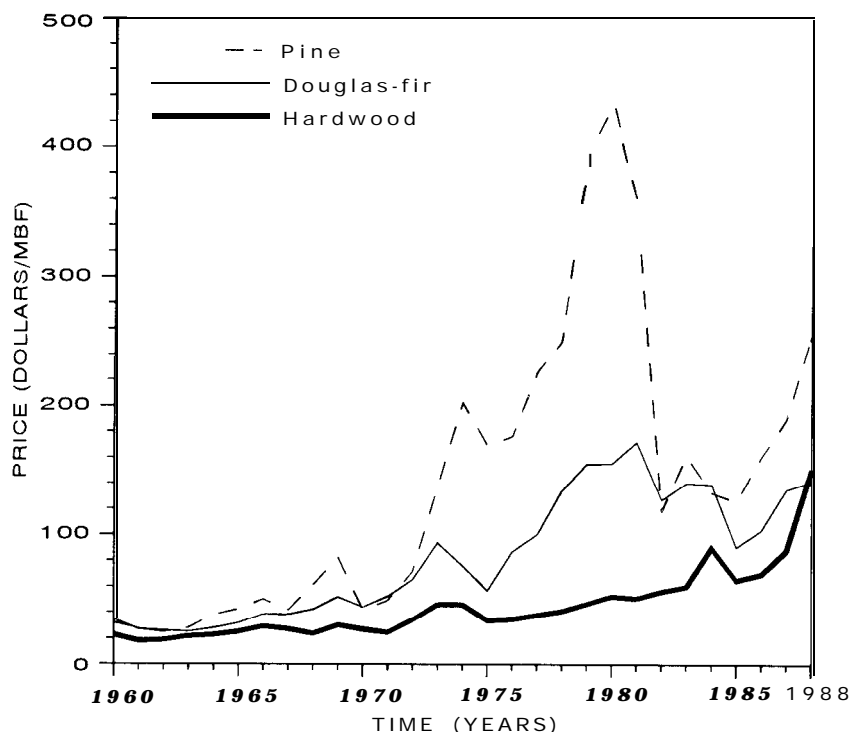


Figure 2.2.--*Stumpage price series: 1960-88* (Source: Ulrich, Alice H. 1989. *U.S. timber production, trade, consumption and price statistics 1950-87. Misc. Pub. 1471. Washington, DC U.S. Department of Agriculture, Forest Service. 77p.*)

elsewhere. Similarly, a reforestation investment must be carried for the length of the rotation. Annual operating and management costs also accumulate and increase the direct burden of holding young timber until it becomes merchantable or of holding merchantable trees for additional growth. Any increase in the interest cost will discourage holding growing stock and shorten the rotation. This is illustrated in figure 2.3 with an 8.24-percent compound interest curve--cost/income curve--that begins with the cost of reforestation in year zero and includes the intermediate annual expenses of property taxes and management costs (the cost aspect of the curve). The 8.24-percent rate is the internal rate of return (IRR). It is found by setting the sum of discounted costs equal to the sum of discounted revenues for this investment and solving for the interest rate that makes them equal. An example of this calculation is shown in the valuation section of chapter 4. The cost/income curve not only represents the accumulating cost of carrying the investment in reforestation and annual expenses, but it also shows the income potential of expected returns from its point of tangency with the value growth (liquidation) curve of

land and timber. The value growth curve is identical to the medium price curve in figure 2.1. An optimum investment length for the assumed inputs--site preparation and planting, \$150 per acre; annual management costs and property taxes, \$5 per acre; a no-thin management regime with stumpage prices of \$15 per cord for pulpwood, \$35 per cord for chip-n-saw logs, and \$135 per MBF for sawtimber--is approximately 25 years at a cost of capital of 6 percent. There is a decision window of plus or minus approximately 3 years, which causes little change in the potential income to be received if the stand is harvested prior to the optimum rotation curve or carried beyond that point. The decision window shows one of the key advantages of a timber investment (that is, trees store well and continue growing). First, the owner has the flexibility to take timber income when it fits best with other ownership goals. Second, the owner can try to maximize income by marketing when he (she) feels that it will bring the highest stumpage price. Any combination of prompt reforestation (to minimize costs), low interest rates, and low annual costs that hold down the cost curve will increase the rotation length and the maximum

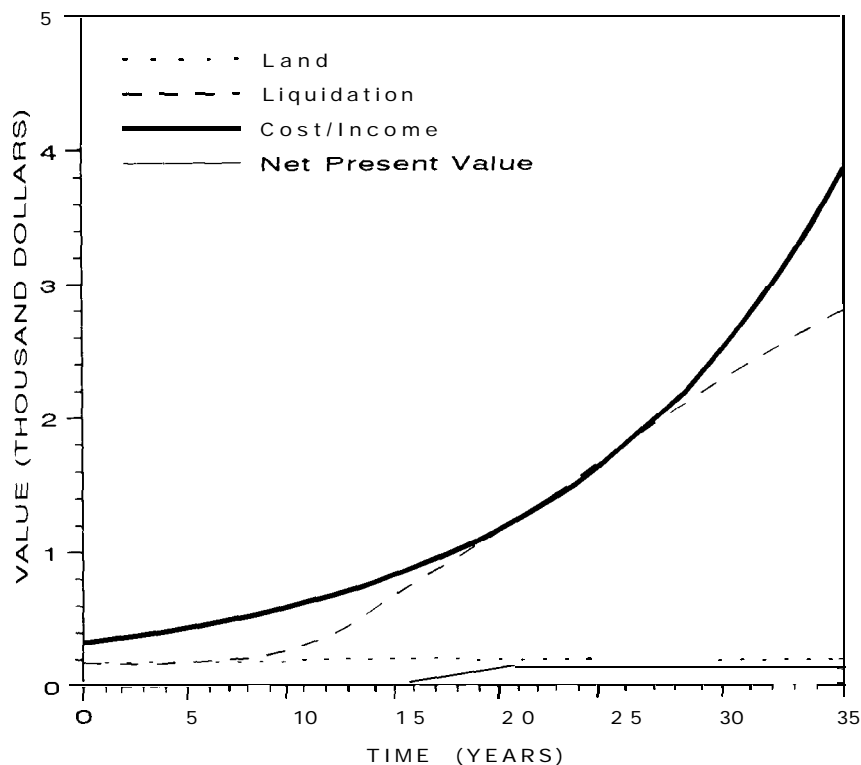


Figure 2.3.-- Timing of timber investment and harvest decisions based on cost/income and liquidation values (loblolly pine on an average site with a net present value at 6.00 percent and an internal rate of return at 8.24 percent).

price that can be paid for land to grow trees. Similarly, any combination of increased price, higher value products, and higher yields shifts the value growth curve upward, shortens the rotation, and also increases the maximum price that can be bid for land. This is another way of saying that costs, prices, and land productivity are logically connected. The lower the costs--such as land, reforestation, taxes, and interest charges--and the higher the returns--such as timber sale prices, hunting leases, and incentive payments, if any--the higher will be the rate of return on the tree farm investment and its asset value, and vice versa.

### Low, Irregular Income

**Low Income.**--Low or inadequate returns on forestry assets often result from premature harvesting, overcutting, and underinvesting in reforestation and maintenance of timber growing stock. The result is that the potential of the timberland is not realized. This condition has basically the same effect as shifting the value growth curve down (see fig. 2.1). Thus the rotation becomes longer, and there is less timber to harvest.

**Irregular Income.**--Irregular income occurs for similar reasons because most nonindustrial private timber properties are not managed to provide an even flow of income. The average tenure of nonindustrial woodland holdings is approximately 10 years, whereas a timber rotation may vary from 25 to 50 years. Then too, the average owner's age is well over 50 years. This combination of 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.

There are four revenue zones in even-aged forest stands that further illustrate the potential for low, irregular income (see fig. 2.4) under various circumstances. The revenue zones vary by species, site, age, and condition of the growing stock. The following southern and western management regimes illustrate the point.

1. Southern regime--even-aged loblolly pine stands on average sites (site index 60, base age 25).
  - a. The income potential for premerchantable trees of 1 to 12 years of age, if liquidated

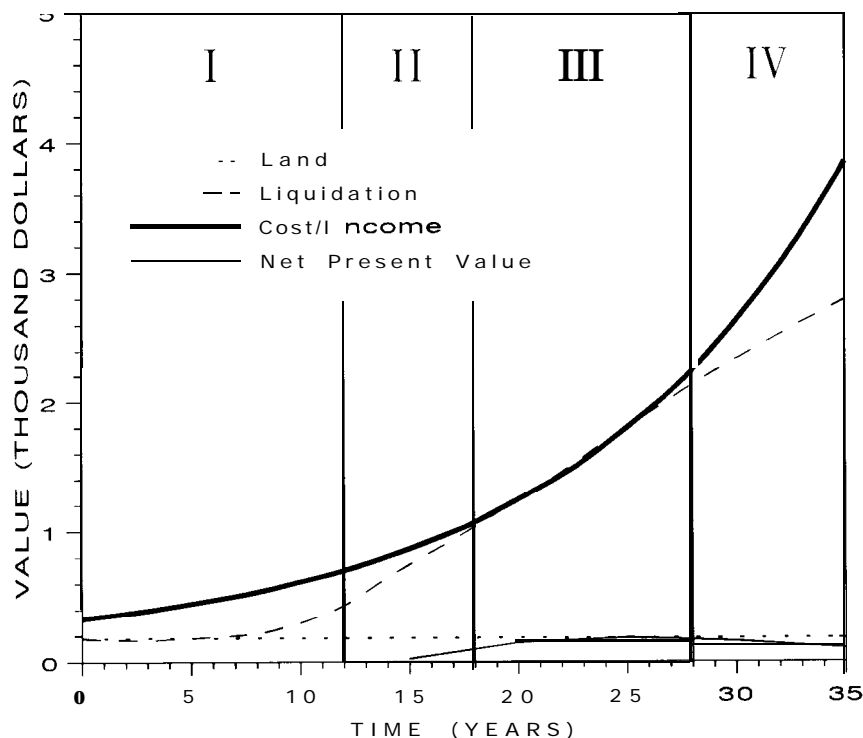


Figure 2.4.-- *Timber income liquidity Zones on a per acre basis and the decision window for final harvest based on cost/income and liquidation values (loblolly pine on an average site with a net present value at 6.00 percent and an internal rate of return at 8.24 percent).*

severed from the or land (zone I) is practically zero (see fig. 2.4). Note, however, that the cost/income curve shows that land and timber is an appreciating asset that begins increasing in value from the time of reforestation. From a practical point of view, there is some evidence that actual prices in zone I may be more heavily discounted by the market than the internal rate of return reflected by the cost/income curve in figure 2.4 would suggest.'

the unit cost for handling each product decreases, and as timber volumes per acre increase, the harvesting cost per acre decreases. Both situations contribute to an increase in the net value of stumpage for the landowner. However, note that a harvest in zone II will result in a sacrifice in total net revenue as illustrated by the gap (vertical distance) between the liquidation curve for land and timber and the cost/income curve for land and timber values (see fig. 2.4).

b. In zone II, the income potential improves with opportunities to thin for pulpwood or to liquidate chip-n-saw logs (small sawtimber) in stands aged 13 to 18 years. This is a period of very high rates of value appreciation as trees increase in merchantable size. The increase in size yields a product mix that crosses the threshold between pulp fiber and solid wood products and contributes to the rise in value. This potential increase is greatest where sharp differentials exist among different classes of products--pulpwood, chip-n-saw, and sawtimber. As individual tree volumes increase,

c. An optimum financial rotation occurs in zone III. This is the harvest timing that gives the highest rate of return or the greatest increase in owner wealth. It is shown in figure 2.3 as the point where the slope of the liquidation (value growth) curve equals the slope of the cost/income curve. The stand value continues to increase, but at a decreasing rate, whereas the cost/income curve is geometrically increasing. This zone includes timber from 19 to 28 years of age, depending on site quality, silvicultural practices, and the discount rate. The decision window for a final harvest extends to 3 or 4 years on either

side of an optimum rotation for a particular set of assumptions so that the potential for loss of income is minimized. Landowner goals, estate goals, and the market hold the key to optimum harvest decisions for particular sets of circumstances.

- d. The final zone (zone IV) extends beyond a stand's economic maturity (30 to 40 years). Here income losses occur from a deceleration of the rate of value appreciation because of insect and disease losses and decreased vigor. Such losses reduce the actual rate of return far below the opportunity for a higher rate of return from a new stand. Many factors may influence a landowner's decision to hold onto timber until it enters this zone. For example, it is often said, "That (timber) is my insurance policy! It is like money in the bank." Some owners are also reluctant to pay the income tax on harvest profits from highly appreciated stands, or they value esthetics or let other considerations influence their decisions.
- 2 Western regime--primarily Douglas-fir stands on average sites. The same landowner considerations come into play, but other factors such as growth rates, scale of operations, land use history, the influence of public timber ownership, and regulations produce a vastly different management environment that affects landowner decisions. Thresholds between the zones are constantly changing as utilization standards, timber prices, and other inputs vary. Increased demand and the resulting higher prices have altered the economics of growing private timber in the West in the last decade.
  - a. The zone of limited income from mostly premerchantable trees occurs from ages 1 to 25 years if they have to be liquidated or severed from the land (zone I). Value appreciation rises at increasing rates over time, but actual values may be heavily discounted by the market.
  - b. Limited income potential is possible for thinning in pulpwood and small sawtimber stands of 26 to 35 years of age (zone II). These stands are also in the zone of very high rates of value appreciation from **ingrowth** as increases in timber size cross

the threshold from pulp fiber to solid wood products (zone II).

- c. Excellent income potential is possible as timber matures into sawlogs, peelers for plywood, and export material within plus or minus 5 years of an optimum rotation in the range of 36 to 50 years of age (zone III).
- d. The rate of financial return declines as timber is held beyond its economic maturity (approximately 51 years plus) due to losses from insects, diseases, decreased vigor, and the opportunity cost of a new stand (zone IV).

### **Continuity of Management**

Continuous long-term management under a well-defined set of goals is the most effective way to insure efficient timber production from forest holdings. This goal is clearly desirable from a societal point of view. From an owner's perspective, its primary importance is from the standpoint of keeping timber assets productive. Continuity of management, however, for all its public and private benefits, is often at variance with an owner's immediate goals and personal situation. Many variables affect an owner's particular management and harvest decisions that may interrupt the continuity of management associated with an optimum return as depicted in figure 2.3. As noted above, the average tenure of nonindustrial private timberland owners 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 timber property, thus contributing to the liquidation of growing stock and disrupting management continuity. Partitioning the estate often produces similar results. Careful planning is required to insure continuity of management and the attendant benefits.

### **Unitary Nature of the Forest**

Economies of scale in management, harvesting, and reforestation are generally 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 woodland size increases the cost per acre of reforestation, harvesting, and management operations will decrease.

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  $[(40 \text{ years}/5 \text{ years}) \times 20 \text{ acres}]$  minimum of operable land stocked with age classes at 5 year intervals is required. If annual income is desired, an 800 acre minimum holding would be required (clearcut management with no thinnings is assumed). 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 timberland holdings is encouraged by real estate practices and estate tax policies. Consider a 1,000 acre timber 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 were equalized externally 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 operations 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 located on four parcels of approximately equal size. The timber corresponds roughly to the four zones of figure 2.4. A timber management plan will include an inventory of the tree farm's timber stands by species, age, 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 in zone IV 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, and (5) many combinations of the above. The plan will depend on the timber market, family needs for income, and the biological condition of the forest. A forester can transform the tree farm inventory into the most effective operational plan to meet owner goals and to utilize the maximum potential of the forest.

### **Difficulty in Obtaining Credit**

Forests are unimproved real estate and largely unproductive in zones I and II (see fig. 2.4). A timberland owner, typically over 50 years of age, with standing in the community and with forestry experience, should have excellent credit. It may be more difficult initially for surviving spouses to obtain credit, if they do not have a proven credit record of their own. It may be even more difficult for the children. The loss of income and family leadership exacerbate 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 or other beneficiaries. With respect to timberland in the estate, a forest management plan is essential to both the goal of producing income and to that of preserving the land's inherent productivity. The plan should have both an operational and a strategic dimension. An operational plan focuses on the production of net income over a relatively short planning horizon, typically 5 years. Beginning with the current inventory, all forestry operations during this period, together with their related costs and revenues, are scheduled. These would include such activities as thinnings, harvest/reforestation decisions, timber stand improvement work, and wildlife management practices. Annual budgets within this plan are developed to meet owner objectives, subject to the constraints imposed by the timber inventory and the market environment.

A good plan has the flexibility to make adjustments: (1) in revenues as owner needs and/or market conditions fluctuate, (2) on expenditures as liquidity and the cost of capital vary, and (3) as unexpected external factors such as changes in public policies and casualty losses interject themselves.

The short-term operational plan functions logically within the context of a strategic plan, which is developed to meet long-term forest management goals for the timberland. Species selection, stocking levels, and rotations are addressed in the strategic plan, as well as the relationships among timber, wildlife, esthetics, and other goals.

In developing a forest management plan, the scope and sophistication will depend on the particular facts and circumstances of each situation as noted above. For limited acreage and modest timber values, a relatively simple plan may enable an owner to achieve his (her) timberland objectives. As the acreage and timber values increase, however, the attention devoted to the plan should increasingly reflect the investment in the resource and its potential earning capacity.

### **SPECIFIC OBJECTIVES**

The members of the family perhaps will have some difficulty in agreeing on the planning objectives for the estate and its timber property. It may not be easy to do, but it is necessary for development of the estate plan. Problems arise because most estate plans have multiple objectives. Invariably, conflicts arise among the competing objectives that must be solved before progress on the plan can be made. It is rarely possible to satisfy all objectives completely, so priorities have to be established for allocation of 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 deals with the choices between current and future consumption (that is, enjoyment by this generation or the next). Equity deals with the shares of inheritance among the heirs, special needs of certain family members, and contributions by various family members in 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. Maximum tax savings may not always be the most desirable end. Finally, there is the element of trust. If members of the immediate family and the in-laws do not have respect and trust among themselves, the planning effort becomes more difficult.

### **Pre- and Postretirement Security**

Adequate resources should be allocated for the financial security and well-being of the estate owner 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**

The financial security, comfort, and happiness of the surviving spouse, either husband or wife, should perhaps be the highest priority for most 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 and often at considerable sacrifice. The death of either spouse is usually followed by a period of adjustment with respect to both personal and business affairs. Arranging for 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 that the survivor has over his (her) resources.

State law usually provides for a 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 will be developed in part IV. Proper planning can determine if the amount to be left to the survivor in the event of either spouse's death will be adequate. Specific adjustments 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 be satisfactory in terms of the specific needs of disadvantaged children, nor does it



necessarily reflect a particular child's contribution to building the estate or caring for the parents during their aging years. Other considerations 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 financial contribution from a child to the parents in money or in kind, (4) care for children with physical or mental handicaps, and (5) differing contributions in managing the woodland. Equitable adjustments for these types of situations can be specifically addressed by the will and other planning techniques. A realistic assessment of 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 Timber Enterprise**

The time required to settle an estate will generally vary between several months and several years, depending on the complexity of the settlement. Plans should be made for continuity of management of the woodland, 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) is also important. Proper planning will insure that an operational timber management plan continues in force. The will or other instrument should direct that business operations of the estate continue during the critical transition period.

The long-term plan must recognize the needs and contributions of both spouses, as well as those of the children. It should also be structured to the greatest extent possible to insure continued operations after the death of the decedent.

### **Minimize Transfer Costs**

Generally, one of the principal goals of estate planning is to minimize the impact of transfer costs at death. As discussed earlier, 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 disposal is required. Gifts made during the decedent's lifetime may be

subject to gift taxes. Gifts have specific advantages and disadvantages that are discussed in chapter 8. Property given to the spouse during the decedent's life or at death is shielded from tax by the marital deduction, but this only defers the ultimate payment of the tax as discussed in chapter 6. State death taxes, which vary greatly in scope among States, must also be considered. Careful planning is required to minimize taxes without jeopardizing other objectives. This requires that a husband and wife make a fundamental choice: (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 the overall objectives.

### **Provide Flexibility and Durability of Plan**

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

## **ESTATE PLANNING TEAM FOR FOREST LANDOWNERS**

### **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 laws affecting 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 guides the formation and articulation of owner

objectives, 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 supervision of changes in property titles and insurance beneficiaries to conform them 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.

### **Banker**

A banker, who may be both lender and corporate trustee, often has an awareness of the financial needs of the estate. The banker can help explain the financial and tax aspects of alternative planning choices. He (she) has expertise in the trust department that can be utilized during the decedent's lifetime and also later by the survivors and 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 10.

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

A CLU can develop an insurance program that will provide the kind and amount of life 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, insure 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.

### **Forester**

A forester is not a member of the traditional estate planning groups; nevertheless, he (she) provides an invaluable service if there are substantial timber 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. The forest management plan will include projections of capital expenditures and management expenses on the cost side, and projected timber revenues on the income side. These projections are then worked into operational plans that meet net revenue targets specified by the owner's estate plan objectives. Operational plans are typically prepared for 5-year intervals as part of the longer range strategic management plans. The strategic plan is designed to provide a long-range view of cash flow levels that are consistent with the amount and distribution of the timber assets. The forester routinely brings management, marketing, and harvesting skills to the planning process, but often has knowledge of timber tax issues and how they interact with other estate considerations.

### **Inventory**

Consultations with professional advisors should be preceded by a personal fact-finding process that includes an analysis of the family situation, and current and projected lifestyle desires and financial needs. The fact-finding process also includes an inventory encompassing 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 also be listed. Projected values for all assets should be made for the next 5 years. The forest management plan will provide the basis for timber volume and value projections. Insurance policies, beneficiary designations, and policy options need to be reviewed.

## Chapter 3

### The Federal Estate and Gift Tax Process

#### BACKGROUND

Since 1916, the Federal government has imposed a tax (the estate tax) on the transfer of a decedent's estate, and since 1932, a tax (the gift tax) on the *intervivos* (lifetime) transfer of property by individuals. Over the years, the two taxes have undergone many changes; prior to 1977 they were independent of one another. Since that year, however, the two levies have been companion taxes that must be considered together in the context of estate planning.

#### UNIFIED RATES

Federal estate and gift tax rates were unified into one rate schedule by the 1976 Tax Reform Act. The rate brackets for both gifts and estates became identical at the time. As shown in table 3.1, the rates in the unified schedule range from a low of 18 to a high of 55 percent on transfers over \$3 million. An additional 5-percent surtax was imposed through 1992 on transfers in excess of \$10,000,000 but not exceeding \$21,040,000. After 1992, the top amount for the 5-percent surtax dropped to \$18,340,000.

#### UNIFIED CREDIT

The 1976 Act also established a unified estate and gift tax credit to offset taxes owed. The credit has been increased in steps; it reached its current maximum of \$192,800 in 1987. This amount effectively shields \$600,000 (the exemption equivalent) of estate and/or gift assets from Federal taxes. As can be seen by examining the rate schedule in table 3.1, the lowest effective estate/gift tax rate is now 37 percent because of the fully phased in credit.

The use of the credit begins with taxable gifts made during the decedent's lifetime. It is mandatory that the credit be applied to such gifts--no tax is actually paid on a taxable gift until the credit is completely used up. Thus, some or all of the credit may be exhausted during a decedent's lifetime and, therefore, 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. The value of a gift for gift tax purposes is its fair market value on the date of the 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 both 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.

**Valuation.**--Once property interests have been established, they must be valued. Valuation of both timber and nontimber assets is discussed in detail in the next chapter. 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 is also possible for timber property and certain other types of estate assets as discussed extensively in chapter 13. 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 and applies to all property in the gross estate. The executor may not alternately value some assets and not others. The return may be filed late without invalidating the election if it is filed no later than 1 year after its due date. The election is also irrevocable--at least after the time for filing has expired.

Table 3.1-- **Federal unified estate and gift tax rate schedule**

Amount on Which Tentative Tax is Computed	Tentative Tax
Not over \$10,000	18 % of such amount
Over \$10,000 but not over \$20,000	\$1,800 plus 20% of the excess of such amount over \$10,000
Over \$20,000 but not over \$40,000	\$3,800 plus 22% of the excess of such amount over \$20,000
Over \$40,000 but not over \$60,000	\$8,200 plus 24% of the excess of such amount over \$40,000
Over \$60,000 but not over \$80,000	\$13,000 plus 26% of the excess of such amount over \$60,000
Over \$80,000 but not over \$100,000	\$18,200 plus 28% of the excess of such amount over \$80,000
Over \$100,000 but not over \$150,000	\$23,800 plus 30% of the excess of such amount over \$100,000
Over \$150,000 but not over \$250,000	\$38,800 plus 32% of the excess of such amount over \$150,000
Over \$250,000 but not over \$500,000	\$70,800 plus 34% of the excess of such amount over \$250,000
Over \$500,000 but not over \$750,000	\$155,800 plus 37% of the excess of such amount over \$500,000
Over \$750,000 but not over \$1 ,000,000	\$248,300 plus 39 % of the excess of such amount over \$750,000
Over \$1,000,000 but not over \$1,250,000	\$345,800 plus 41% of the excess of such amount over \$1 ,000,000
Over \$1,250,000 but not over \$1,500,000	\$448,300 plus 43 % of the excess of such amount over \$1,250,000
Over \$1,500,000 but not over \$2,000,000	\$555,800 plus 45 % of the excess of such amount over \$1,500,000
Over \$2,000,000 but not over \$2,500,000	\$780,800 plus 49% of the excess of such amount over \$2,000,000
Over \$2,500,000 but not over \$3,000,000	\$1,025,800 plus 53 % of the excess over \$2,500,000
Over \$3,000,000	\$1,290,800 plus 55% of the excess over \$3,000,000

## Taxable Estate

The definition of taxable estate is the value of the gross estate less all permitted deductions. These are six in number: funeral expenses, estate administration expenses, debts, casualty and theft losses, the charitable deduction, and the marital deduction.

**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 Veterans Administration 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 the 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 and preservation of estate property, payment of estate debts, and distribution of estate assets. The IRS considers only those administration expenses "actually and necessarily" incurred for such purposes to be deductible.

**De&.--These** are personal obligations of the decedent that exist at the time of death, including interest accrued to the date of death. They encompass such obligations as mortgages, liens, unpaid income taxes on income includable on a return of a 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. Interest expenses accruing after death on debts incurred prior to death generally are not allowed as a deduction. Several courts, however, have not always followed the IRS position on this and 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 beneficiary. 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.

**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 Federal government, a State government, and State political subdivision entities if the transferred assets are used exclusively for public purposes; corporations organized and operated (not necessarily in the United States) 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 passing from the decedent to his (her) surviving spouse is permitted to be deducted from the decedent's gross estate. Treasury Regulation 20:2056(e)-2(e) provides that in case of simultaneous death, a presumption (whether by local law, will, or otherwise) that one spouse or the other was the first to die will be recognized.

## 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 includable in the gross estate. Life-time gifts that must be included in the gross estate are discussed in chapter 8. The rate schedule is then applied to this total, resulting in the tentative 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. 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 rate 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 tax due. There are five such credits: the unified credit discussed earlier, the State death tax credit, the credit for Federal gift taxes on pre-1977 transfers, the foreign death tax credit, and the credit for Federal estate taxes on prior transfers.

**Unified Credit.**--The amount of the unified credit available at the decedent's death (\$192,800 minus any credit used for 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 life-time gift exemption of \$30,000 was permitted. The unified credit 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 his (her) entire lifetime exemption of \$30,000, the unified credit would be reduced by \$6,000 (20 percent of \$30,000).

**State Death Taxes.**--A limited credit for State death taxes is allowed (see appendix page 134). It is determined by applying a rate schedule to the value of the taxable estate reduced by \$60,000.

**Gift Tax Credit.**--This credit is determined by first computing the tax on the cumulative total of lifetime and death taxable transfers. The tax previously paid (or payable) on the lifetime transfers is then deducted.

**Estate Tax Credit.**--A credit is allowed for the Federal estate tax paid on transfers to the decedent of property from a transferor who died within 10 years before or 2 years after the 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 decedent's death, full credit is allowed. If the transferor dies more than 2 years before the decedent,

the credit is reduced by 2 percent for each 2-year period.

**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 is actually situated in a foreign country. The credit is the lesser of the foreign death tax or the Federal estate tax attributable to the property.

## Estate Tax Computation

**Example 3.1.** Assume that the decedent died in 1988 with a gross estate valued at \$607,800. In 1979, the decedent had made a lifetime gift of property valued at \$253,000 to his daughter. He had filed a gift tax return and paid a net gift tax of \$34,800 (tentative gift tax of \$70,800 minus the unified credit available at that time of \$38,000). There were no other lifetime gifts.

The decedent's gross estate includes the gift taxes paid but not the value of the gift. The taxable portion of the gift, however, is added to the taxable estate to determine the tentative tax, as discussed above, because the gift is not included in the gross estate. The net estate tax is computed as follows:

Gross estate	\$607,800
Minus debts and administrative expenses	<u>(107,800)</u>
Taxable estate	500,000
Add adjusted taxable gifts (\$253,000 minus the \$3,000 annual exclusion that prevailed in 1979)	<u>250,000</u>
Taxable amount	750,000
Tentative tax	248,300
Minus gift tax paid (or payable)	( 34,800)
Gross estate tax	213,500
Minus unified credit	<u>(192,800)</u>
Subtotal	20,700
Minus State death tax credit	<u>10,000)</u>
Net estate tax due	\$ 10,700

## Chapter 4

### Valuation of Assets for Estate and Gift Purposes

#### GENERAL CONSIDERATIONS

The unified estate and gift tax is an excise tax that is generally levied on the fair market value (FMV) of property that is gratuitously transferred. The Treasury regulations define 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 is actually being put at the time of the transfer. Although the two uses may be the same, often they are not. An exception to the FMV rule permits certain property to sometimes be valued on the basis of actual use if such value is lower than fair market value. The applicability of this rule to timber properties is discussed in chapter 13.

Establishment of FMV for certain estate assets is sometimes an elusive process. The estate planner must, therefore, anticipate disagreements over valuations of some types of property. If the value of an item on the estate tax return is challenged, the law permits an 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 by the IRS in arriving at value; and (3) a copy of any expert appraisal made for the IRS.

#### Undervaluation

A “valuation understatement,” resulting in penalties, occurs if the value of any property listed on an estate or gift tax return is two-thirds or less of the amount determined to be the correct valuation. A graduated penalty, as follows, applies:

- (1) for claimed valuations between 662/3 and 50

percent of the correct value, 10 percent of the tax liability understatement;

- (2) for claimed valuations between 50 and 40 percent of the correct value, 20 percent of the tax liability understatement; and

- (3) for claimed valuations less than 40 percent of the correct value, 30 percent of the tax liability understatement.

The penalty does not apply if the understated tax liability is less than \$1,000. The IRS may waive all or part of the penalty if it can be shown that there was a reasonable basis for the valuation claimed and that it was made in good faith.

#### Interaction between Stepped-up Basis and Estate Tax

In some cases, undervaluation, even though it may save estate taxes if unchallenged, could be detrimental from an income tax standpoint, particularly for timber properties. The timber (as does all other estate property) receives a stepped-up basis for income tax purposes equal to its valuation on the estate tax return. In the event the timber is subsequently sold by either the estate or the heirs, the higher the basis, the less income tax due. The basis is deducted from the sale proceeds to determine taxable gain. The taxpayer’s combined income tax marginal rate (State plus Federal) could, in some instances, be higher than the marginal death tax rate (Federal estate tax plus State death tax). Undervaluation on the Federal return in such a case would result in a higher total tax bill (death taxes plus income taxes) than would otherwise be the case with no undervaluation.

#### State Death Tax Considerations

If the estate is not large enough to require filing a Federal estate tax return, the same caution applies. The State death tax marginal rate always will be less than the Federal and State combined marginal income tax rate. Undervaluation of timber on the State death tax return in such a case will mean a higher income tax bill than would otherwise be the case, when the timber is subsequently sold.

## SPECIAL CONSIDERATIONS

### Closely Held Corporate Stock

Many nonindustrial timber ownerships are part of closely held family corporations. The decedent's stock in such a business is usually an illiquid asset. For estate and gift tax purposes, it can present difficult valuation problems. Because there is no established market, what valuation criteria should be used? Sales within the family are not reliable. And, as discussed earlier, a penalty may be imposed if the value reported is two-thirds or less of real value.

**Factors to Consider.**--Although many factors should be considered in valuing closely held corporate stock, a number are common to most situations. These include:

- (1) the nature and history of the business--such as the 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) sale of stock; and
- (8) the market price of stock of similar corporations.

Depending on the circumstances, some of these factors carry more weight than others. Generally, in a family-owned timber corporation, the greatest weight is accorded to the underlying timber assets. The courts have allowed discounts of 10 to 50 percent because of the difficulty of selling closely held stock, especially for minority interests.

### Partnership Capital Accounts

Many nonindustrial timber properties are also held in family or nonfamily partnership form. A partner's capital account in the partnership is initially equal to the value of money and property that he (she) contributed to the partnership. It subsequently also reflects the partner's share of profits minus any losses or 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. But the IRS also considers the value of the business as a going concern--the price a willing buyer would pay and a willing seller accept for the assets, goodwill, and demonstrated earning capacity. This valuation would particularly be true if the partnership continues rather than is dissolved.

### Life Insurance

The value of a life insurance policy owned by the decedent, on the life of a person other than the decedent, is generally the amount the company would charge for a comparable policy on the date of the decedent's death. An insurance policy on the life of the decedent that is includable in his (her) gross estate has a value equal to the proceeds payable by the policy. Chapter 11 discusses in more detail under what circumstances life insurance proceeds are includable in an estate and when they are not.

### Future Interests

The value of property transferred by 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 but which 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 will be discussed in more detail later.

## FOREST LAND AND TIMBER

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



## Methods of Valuation

There are three principal methods used to value real estate including timberland. These are the market transactions (comparison), income, and cost approaches. One of these methods is usually selected as the primary procedure, but a second or even a third approach may be used as a check for accuracy if the other methods are applicable and appropriate data are available. In practice, all methods are ultimately related to the market.

**Market Transactions.**--Fair market value based on a comparison of the "subject property" to similar properties (that is, comparable sales) is generally 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.

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

The timing of a transaction is also an important factor in estimating an asset's value. Here the important date is the actual "meeting of the minds" of the buyer and seller rather than the date of recording the deed or other paperwork for the record. The sale value 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 do not adjust for inflation may

distort estimates of value, if not properly 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 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. The future values are discounted to the present using a chosen interest (discount) rate. Reasonable estimates of future revenues and future costs may be obtained for many business situations based on past experience. Future values cannot be known with certainty, but the discounting process weighs the near term cash flows more heavily than those that will occur in the more distant future. This makes the choice of the discount rate very critical. It should reflect the opportunity cost of the resources committed to the project as opposed to an alternative use. One problem is that prior experience does not account for future technological change.

It is essential that the components 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 an item 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 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. Many properties have been over-improved or under-improved. For example, the excessive cost for bridge standards higher than necessary for efficient management will not be reflected in value. Finally, cost must be economically warranted. Cost reflects 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 net income stream. Replacement cost is limited by the market to the cost of an item of comparable quality to that being replaced. This is frequently different from reproduction cost due to improvements in both materials and management methods, whether for trees or other properties.

## Valuation of Bare Land

In valuing forest land, the market transactions approach is generally the most reliable. However, if appropriate data are available, the income approach may also be used as a check for accuracy. The cost approach, is inappropriate for bare land because no additional supply of land can be created. Obsolescence, a key component of the cost approach, is a valid consideration only with respect to improvements to property--such as bridges, fences, and buildings--but not with respect to the land itself or to trees, which are an appreciating asset. Similarly, an excessive cost for mechanical site preparation, versus chemical use at a lower cost and to obtain the same results, will not be reflected in land values.

**Market Approach to Value.--**The most reliable method of estimating land value compares the property to sales of similar properties in comparable locations within the same time period. 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.

The most important requirement with respect to the market approach is access to current sources of 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' sales files. Several sources may be used to obtain a sufficient volume of transactions to evaluate the level of economic activity, price trends, and shifts in timber industry growth 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 timberland have traditionally been private, and the public may not receive a true picture of the factual circumstances of the transaction. The price paid may differ from a price paid in the open market due to financing terms, relationship of the parties, or other collateral factors. The time of the comparable transfer should also 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, the transaction should not be included in the sample for comparative purposes.

With respect to timberland, there are many variables that should be taken into account in order for

sale transfers to be comparable. These include site productivity, operability and accessibility 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 timberland market tends to be highly local in character. Even the assumption of indestructibility must sometimes be altered for the effects of erosion, soil compaction, and chemical pollution that may alter productivity and ultimately value. Most comparable sales include both land and timber, and many reflect alternative uses of the land.

**Income Approach to Value.--**With this method, the value of land is based on its income-producing capacity (productivity) in its "highest and best use." This approach is used when market transactions are limited or nonexistent for comparisons with the property of interest. The income from the land during an investment cycle is what is left after all the costs of production--labor, management, maintenance, and the opportunity cost of capital--are deducted. If this amount is capitalized (discounted to the present) at an appropriate interest rate, the result is an estimate of the present value of the property. Generally, an individual investor's interest rate is his (her) highest "alternative rate of return" if the funds were to be invested elsewhere. Discounted revenue minus discounted costs for one investment period is known as net present value. Net present value calculated for an infinite investment horizon of timber rotations is known as land expectation value. It is the maximum bid price for land suitable for growing timber with the assumed cash flows.

Determining the "highest and best use" is a critical assumption of the income approach to valuation of bare land. Again, the unitary nature of land must be considered. For example, a timber property with good road frontage may have a higher value for the areas near the road for strip real estate development than for timber growing. The negative impact on the balance of the property would have to be considered if forest management operations were restricted in the higher valued areas. All such negative impacts should be netted against development revenues in determination of the "highest and best use" for such properties.

## Valuation of Merchantable Timber

Timberland in an estate is frequently valued as a unit; that is, separate valuations are not determined for

land and timber. This is a mistake that should not be made. Serious income tax consequences could result, due to the lack of an identifiable timber basis, when timber is subsequently sold.

**Market Transactions Approach.--**The market value of merchantable timber is what the trees would sell for under the utilization standards used in the particular market area of the timber property. The value will be influenced by many factors, such as species, tree size, product class, quality, total volume on the tract, and accessibility. Timber markets, like land markets, are highly localized. Because logs are bulky and transportation is expensive, the market area for most products is constrained. The higher the per unit value of a timber product, the greater the scope of its market area. For stumpage used for fiber, that is firewood, pulpwood, and chipped wood products, the truck haul radius is usually 100 miles or less. Poles, piling, and veneer quality logs, on the other hand, may be transported much greater distances.

If timber must be cut to realize income, it is the liquidation value today rather than the timber's potential value that counts. This is the value shown by the liquidation curve in figure 2.3. Although many comparable sales include the value of the land, the timber value alone can be readily 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 cycle, or at least an assumed management regime where the expected value of the future harvest and the management costs can be estimated. The expected timber revenue less discounted costs and the discounted terminal value (land expectation value as discussed above) incomes are discounted to the present. This residual value is the income value of the timber stand at the intermediate age (see fig. 2.3). Such values are illustrated by the cost/income curve as shown in figure 2.3. The vertical distance between the cost/income curve and the liquidation curve also represents the foregone income that will result if timber is cut either prior to an optimum rotation or if the timber is held longer than an optimum rotation. As has been previously discussed, however, these curves are very flat on either side of the optimum harvest (that is, there is only a small loss of potential income within approximately 3 years on either side of the best harvest age). This provides a "decision window" for scheduling harvests. They may be timed for maximum revenue

by taking advantage of price fluctuations (see fig. 2.3), smoothing income flows, or other specified landowner goals.

**Cost Approach.--**To use the cost approach to obtain estimates of value, the same assumptions discussed under the income approach will hold. In this case, the procedure is used to compound the establishment cost and the intermediate cost flows forward to the present at an appropriate rate of interest.

The cost and the income approaches will provide estimates of value that will differ, based on the interest rate chosen, with one exception. That exception is the special case where the interest rate is equal to the internal rate of return (IRR) for the assumed management regime. In that situation, the cost/income curve showing values compounded forward and the cost/income curve showing values discounted backward from the harvest will be identical (see fig. 2.3). This suggests a method for determining intermediate values for standing timber that has been called the hybrid approach. First, an IRR is computed from all costs and revenues for the investment cycle. Second, the IRR is used as the discount rate to calculate the cost value and/or the income value for the timber investment period. An example of the hybrid approach is found on page 28 under valuation of pre-merchantable timber.

The income valuation approach is the more practical method for merchantable timber simply because the length of time for the projection period (harvest value discounted to intermediate timber value) will normally be shorter than the projected period for compounding establishment costs forward. Thus, with other things being equal, the shorter the period of uncertainty, the less the variance will be in the expected results.

## Valuation of Premerchantable Timber

Satisfactory market transactions for use in valuing premerchantable timber rarely exist. Valuations often must be based on either the income or cost approach. The problems of choosing an appropriate interest rate can be avoided by solving for the IRR for the assumed level of management. The IRR is the compound interest rate that equalizes the present values (PV) of the discounted revenues and the discounted costs, or stated another way, the net present values (NPV) of discounted costs and revenues are equal to zero. For example, assume that net revenue of \$2,075 per acre is received in year 30. Per acre costs include \$150 for site preparation and planting in year 0 and annual

management expenses of \$3.00 per acre. The IRR is calculated by trial and error as follows:

Item	Year	Value	PV @ 9.0%	PV @ 8.5%
Site preparation	0	\$-150.00	\$-150.00	\$-150.00
Management cost	1-30	-3.00	-30.82	-32.24
Harvest revenue	30	2,075.00	<u>156.40</u>	<u>179.53</u>
Net present value			\$ -24.42	\$ -2.71

		PV @ 8.4%	PV @ 8.45%	PV @ 8.44%
Site preparation	0	\$-150.00	\$-150.00	\$-150.00
Management cost	1-30	-32.54	-32.39	-32.49
Harvest revenue	30	<u>184.56</u>	<u>182.03</u>	182.53
Net present value		\$ 2.02	\$ -0.36	\$ 0.04

Thus, the **IRR** that makes NPV equal to zero is approximately 8.44 percent.

**Income Approach.**--When using the income approach, only future costs and returns are considered. Past costs are not included because they are "sunk" and have no bearing on future income. With the IRR calculated to be 8.44 percent, the income value for the stand in the example above can be calculated. To solve for the income value at age 9, for example, the interest calculation is as follows:

Harvest revenue =  
 $\$2,075 \times 0.18240 = \$378.48$   
 (present value of a single sum discounted at 8.44 % for 21 years)

Management cost =  
 $\$3.00 \times 9.68723 = \underline{-29.06}$   
 (present value of a terminating annual annuity at 8.44% for 21 years)

Income value = \$349.42

**Cost Approach.**--Again, with the IRR known, the cost approach to value works like the income approach except that the establishment cost, including intermediate costs and revenues, are compounded forward to the intermediate age of the premerchantable timber. In the example, the age is 9 years and the calculation is as follows:

Site preparation and planting =  
 $\$150.00 \times 2.07351 = \$311.03$   
 (future value of a single sum at 8.44% for 9 years)

Management cost =  
 $\$3.00 \times 12.71928 = \underline{38.16}$   
 (future value of terminating annual annuity at 8.44 % for 9 years)

Cost value = \$349.19

Note that both the income and the cost approaches give the same estimate of premerchantable value except for rounding error (\$0.43). Note also that the opportunity cost of land is not included in the calculation because it is common to both cases and, therefore, can be excluded.

The hybrid approach has the distinct advantage of eliminating one of the most critical assumptions in financial analysis, namely, that of estimating a discount rate. The use of the IRR for compounding and discounting the cash flows associated with both the cost approach and the income approach will give the identical answer (ignoring the rounding error). This, of course, is not the case when a discount rate other than the IRR is used.

### Court Decisions--Gift Tax

*Saunders v. U.S.*, 81-2 U.S. Tax Cas. (CCH) P13,419; 48 A.F.T.R. 2d (P-H) 6279 (1981).--Here the court held that the value of gifted timberland subject to a long-term lease was the present value (using a discount 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. Nevertheless, the valuation was technically flawed because real cash flows (without inflation) and a current discount rate (with inflation) were used in the discounting formula. This procedure is inconsistent and resulted in undervaluation of the assets.

*J. A. Hipp et al. v. Commissioner of Internal Revenue* 47 CCH Tax Ct Memo 623 (1983).--The Tax Court determined the fair market value of timberland 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.

### Court Decisions--Estate Tax

*Estate of Sturgis v. Commissioner of Internal Revenue* T.C. Memo. 1987-415.--The Tax Court set the value of 11,299 acres of timberland at an amount between those offered by the estate and by the government. The court considered the testimony of four

experts, each of whom valued the property using the same methodology. First, the volume of timber on the property was determined with a separate value given to each species. Then, the land was valued as a separate component and added to the timber values. 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 timberland which comprised 91 separate tracts. (For a comprehensive discussion of discounting, see pages 29-31.)

William M. Oettmeier, Jr., Personal Representative of The Estate of Russell L. Carter, Deceased, v. United States, U.S. **District Court for the Middle District of Georgia, No. CV-87-49-VAL(WDO), March 16, 1989.**--A so-called "common sense" method was used by the court to value a decedent's interest in leased timberlands 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 discount rate and the appropriate discounting formula. The court rejected the valuations offered by both the estate and the IRS because it held 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; that is, it basically split the difference but curiously used two discounts rates to arrive at its value.

## DISCOUNTING FOR MINORITY AND UNDIVIDED INTERESTS

### General Considerations

There is no authority for discounting fractional interests in either the Internal Revenue Code or the regulations, except the statement in 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 in timberland, particularly if it is a minority ownership, is typically 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 similarly discounted. 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.**--Determination of the amount of the discount is generally more art than science. In disagreements with the IRS, heavy reliance is often placed on expert witness testimony. Among the factors typically addressed by expert witnesses are the following: (1) the difficulty of owners of fractional interests securing purchasers except at substantial discounts; (2) the limits of owners of fractional interests in their control, management, and operation of the property; (3) the inconvenience of dealing with several owners; (4) the possibility of complications caused by owners of very small fractions; and (5) the danger of partition suits.

### Corporate Stock

Among the most important considerations in valuing the stock of a closely held company are the legal and operating rights embodied in the stock ownership. Among the most significant of these rights is the ability of certain stockholders to control a company. Conversely, the lack of control is commonly adjusted for 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, will normally 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. A 20-percent minority interest in one instance may have relatively little to say with respect to operations when only one shareholder controls the other 80 percent. However, the 20-percent shareholder could exist with two others each holding 40 percent, with a shareholder's agreement that at least 51-percent approval be required for certain decisions. 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. In a recently conducted study, the average discount for a minority interest was found to be 30 percent and that for lack of marketability, 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 can also apply to majority holdings. The IRS "Valuation Guide for Income, Estate and Gift Taxes" recognizes that the absence of a readily available market for closely held stock interests may justify a discount for lack of marketability. It 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 the fractional interests other than the interest in question have had a significant influence on whether a discount could be allowed. The courts in many instances have chosen not to discount the interest in question when all the other interests were owned by members of the same family--for example, see *Horace K. Fawcett*, 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. U.S.*, 658 F2d 999 (5th Cir. 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 control 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, 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 exists 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, revoking Revenue Ruling 81-253, and stated that it would subsequently follow the *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. Stock shares transferred should henceforth be valued without regard to the family relationship of the donee to other shareholders.

## Partnership Interests

The principles of Revenue Ruling 59-60 as discussed above (on page 29 pertaining to minority discounts for closely held corporate stock) are applicable also to valuation of minority partnership interests (see Revenue Ruling 68-609). This is illustrated in the *Watts* decision [*Estate of Watts*, TC Memo 1985-595, 51 TCM 60 (1985)]. Here 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 timberland, manufacture of plywood, and sale of lumber. By 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 of the taxpayer's appraisers and discounted the decedent's minority interest by 35 percent. The decision was affirmed by the Fifth Circuit Court of Appeals [*Estate of Watts v. Commissioner*, 87-2 USTC 13,726 (11th Circuit, 1987)].

In the *Harwood* decision [82 TC 239, 267 (1980)], 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

In the *Sels* decision [*Estate of Sels v. Commissioner* (TC #12,642(M)(1984)], 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 timberland was determined by using the comparable sales method of appraisal. The fractional interests ranged from 2.48 to 25.00 percent. The IRS valuation was revised to reflect differences between the comparison lands and the decedent's properties with respect to the quality of

timber, accessibility, and timing of the sales. In addition, the IRS valuation was further reduced by a 60-percent discount 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 have little income in the meantime. The testimony indicated that partition would be expensive and take at least 6 years.





# 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 of 1986, because of the vast changes made by the 1986 Tax Reform Act, the Code 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 every year since 1981, with the exception of 1985, Congress has passed substantial changes. For example, the Revenue Act of 1987 made significant changes in the estate and financial planning area. The 1988 Technical and Miscellaneous Revenue Act, the 1989 Revenue Reconciliation Act, and the 1990 Revenue Reconciliation Act, although billed as technical corrections legislation, also included many new substantive provisions.

#### Administrative Basis

**Regulations.** -- The Internal Revenue Service (IRS) is empowered to administer the Code. 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. The regulations also serve as an enforcement mechanism. Regulations must be issued in proposed form subject to public comment before being published by the IRS in final form. Both statutory and interpretive 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 do 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. Letter rulings are generally 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; they may not be used as precedent by other taxpayers. Letter rulings are available to the public under the Freedom of Information Act. Although not comprising general precedent, they are nevertheless often 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 letter rulings, a TAM is limited in application to the taxpayer who made the request; it, too, may not be used as precedent by other taxpayers. Also available under the Freedom of Information Act, TAM's are often utilized to help interpret IRS positions.

#### Judicial Basis

If a taxpayer disputes the IRS position in a particular matter and the disagreement is unable to 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 can also turn to the Federal District Court System or to the Claims Court. The latter is a single court in Washington, DC. In both cases, the disputed tax must have first been paid. The taxpayer then files 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 Circuit Court of Appeals in whose jurisdiction the taxpayer resides. Appeals from the Claims Court are taken to the Appeals Court for the Federal Circuit. All appellate decisions may be taken to the Supreme Court. As a practical matter, however, very few estate and gift tax matters are accepted by the Supreme Court.

## **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 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 is generally 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 sometimes other expenses. Guardians for minor children can also be named in a will, and charitable bequests specified.

### **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; the portions that do not follow the law are invalid. An attorney should always 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 those forest landowners whose holdings are 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, either in a joint will or in separate wills. Even when State law permits, it is generally 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 provision that restricts 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, 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. In such cases, a new will would have to 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 usually automatically revoked by death or incompetency of the grantor. Therefore, revocable trusts (see page 60) are sometimes 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 is still alive and even if the grantor becomes incompetent.

### **Durable Power of Attorney**

Many States now permit durable powers of attorney, which survive the incompetency of the grantor. For

example, New York law allows a principal to expressly 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.

## PROBATE

Probate is the legal process designed to protect, administer, and distribute a decedent's estate. It includes proving the validity of a will. Probate courts exist for the purpose of protecting the rights of the heirs and/or legatees, supervising the assembling of the estate assets, and assuring 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. It is still necessary for the court in most circumstances 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 husband and wife automatically passes to the survivor upon the death of the other (see chapter 15 for a discussion of joint ownership).

Probate administration includes such matters as the assembling of estate assets, payment of debts, clearing title to estate property, payment of taxes, and distribution of the assets to the heirs/legatees. In most cases, a final income tax return will have to be filed for the decedent. During administration of the estate, one or more fiduciary (estate) income tax returns may also 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. They depend on the attorney's fee schedule, and on the size and complexity of the estate. In addition to the attorney's fee, there will be 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 estate value.



## **PART II**

### **APPLICATION OF GENERAL ESTATE PLANNING TOOLS TO FORESTRY**



## Chapter 6

### Use of the Marital Deduction in Estate Planning

#### OVERVIEW

The marital deduction is a deduction from the adjusted gross estate for property passing to the surviving spouse. It is considered by many to be the most important estate tax saving device available to a decedent's estate. Since 1948, individuals have been eligible for tax-saving opportunities related to property passing to a surviving spouse that were previously available only in community property States. The law has been liberalized several times since then. Finally, the 1981 Economic Recovery Tax Act (ERTA) made deductions for both lifetime and testamentary transfers to spouses "unlimited." Thus, the marital deduction now recognizes the role of both spouses' contributions to building 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. Bequests to spouses who are not U.S. citizens do not qualify for the estate tax marital deduction unless they are in a qualified domestic trust. In order to be considered a qualified domestic trust, the trust instrument must provide that at least one of the trustees be a U.S. citizen or domestic corporation and that any distribution from the trust principal be subject to the U.S. trustee's right to withhold the estate tax due on the distribution.

#### 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. The deduction for both lifetime and testamentary transfers is unlimited. However, the property must actually pass from the decedent to his (her) spouse. The marital deduction is not available to the estate of a widow, a widower, or an unmarried person.

#### 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 decedent must be survived by a spouse, and the property must be passed from the decedent to the surviving spouse. 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 surviving spouse's lifetime.

Generally, no marital deduction is allowed 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 and annuities. Another example is 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. Thus, 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 explained later, there are, however, 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 transfers by State laws of intestate distribution. 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 TERMINAL INTEREST RULE

Basically, each spouse must trust the other implicitly for the marital deduction to work effectively. However, there are five exceptions to the

terminal interest rule, which generally stipulate that the property interests in question will qualify for the marital deduction if certain requirements are met. They will, however, also be taxable in the surviving spouse's estate if not consumed or given away before his (her) death.

### **Qualified Terminal Interest Property**

Property under a qualified terminal interest property (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**

This is the right to determine the ultimate disposition of certain designated property. The survivor must have a life interest that entitles him (her) to all the income (payable at least annually) and must have the power to appoint the property to himself (herself) or his (her) estate.

### **Survivorship Condition**

A bequest to a spouse may be conditioned on his (her) survival for a period up to 6 months after the death of the decedent; or on his (her) survival of a common disaster, providing the spouse does, in fact, survive.

### **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 8) where he (she) is the only noncharitable beneficiary. These conditions apply automatically; however, the executor can elect for these provisions not to apply.

## **QUALIFIED TERMINAL INTEREST PROPERTY 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 can control the disposition of the remainder interest after the surviving spouse's death. The remainder interest will, however, be included in the surviving spouse's estate. For example, timber property may be put into a QTIP, with the value qualifying for the marital deduction. The surviving spouse receives the income from the timber 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 be specifically elected by the executor of the estate on the estate tax return. Once made, it is irrevocable. To qualify, the following conditions must be met: (1) the surviving spouse must be entitled to all of the income from the property payable at least annually for his (her) life, (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 to appoint any part of the property to any person other than the spouse during the spouse's life. The fact that a marital deduction formula (as discussed later in this chapter) is used to determine the amount of property passing to a QTIP does not jeopardize the QTIP election (Letter Ruling 8814002).

## **TO WHAT EXTENT SHOULD THE MARITAL DEDUCTION BE USED?**

Because the unlimited marital deduction is such a powerful planning tool, it should 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 the additional resources efficiently are also factors to be considered.

### Legal Rights

Legal rights of the surviving spouse to take a share of the real property and, in some States, a share of the personal property in the estate must be taken into account in deciding how much and in what form property should pass if it is to qualify for the marital deduction. This, of course, is governed by State law. These decisions are affected by the presence of children from the current and perhaps former marriages of either spouse.

### Nontax factors

Nontax factors that may affect the marital deduction's use include the couple's personal relationship, health and age (life expectancy), and degree of confidence in the spouse's business ability because there is always a tradeoff between control and tax savings. Spousal trust permits equalization of the estate's resources and freedom to use all the planning tools that are available to save taxes. A lack of trust, fear of a spouse's remarriage, and perhaps fear of divorce may force an owner to maintain maximum control, which complicates the planning process.

The surviving spouse's resources and the possibility of inheritances from other sources should also be taken into account in projecting tax outcomes. The needs of young children have to be included here as well. The current value of both spouses' estates and the effects on each other's estate tax return should be considered.

### Marital Deduction Deferral

If the goal is simply to save the maximum estate tax at the death of the first to die, the marital deduction should be used to the fullest extent. A will that states, "I leave everything to my spouse," results in the deferral of all estate tax on the death of the first to die. This may create a huge tax problem for the estate of the second to die, especially if that person already has a substantial estate of his (her) own. The marital deduction defers the tax until the surviving spouse's death; therefore, the aggregate estate taxes of both spouses should be considered. If the survivor's health is good and normal life expectancy is long, the deferral gives time for the

survivor to use the additional resources wisely through additional planning or consumption. A number of tax factors, as follows, should be considered.

**Maximize Credit.**--Maximization of the unified credit in each spouse's estate is the key to use of the marital deduction. The \$192,800 credit permits each spouse to transfer \$600,000 in net taxable estate value to persons other than the other spouse without estate tax. Thus, together, they can pass \$1,200,000 in net taxable value to the children without estate tax cost.

**Example 6.1.** Assume a forest landowner husband owns 1,200 homogeneous acres of timberland with a net value of \$1,200,000 after payment of estate debts and administrative costs. His wife is without assets. (The analysis works the same with husband and wife 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 funeral expenses and administrative costs, her estate will face a Federal estate tax of \$235,000 on the value of the timberland. This equals a 20-percent reduction in estate value. It may have to be paid by selling part of the property or utilizing Section 6166 (see chapter 14) and paying the tax from timber sale income over time. In addition, there is considerable risk from concentrating the assets in one or the other spouse's estates because the spouse without assets might die first, and the unified credit would be wasted. This result would be similar to the situation where the survivor inherits all the assets.

**Balancing the Marital Deduction.**--The goal is to balance the expected values in each estate with adjustments for life expectancy, earning power, and ability to manage the assets.

**Example 6.2.** Assume the same facts as in example 6.1, but now the husband makes an outright bequest of \$600,000 in timberland value (600 acres) to the children, which is protected from estate tax by the unified credit. He wills the balance to his wife with a marital deduction bequest, and his estate also pays no estate tax on that portion (600 acres). When the wife dies, her estate has a \$600,000 exemption equivalent so that no estate tax is owed and the children have saved \$235,000. The disadvantage here, however, is that the wife did not have control of half of the timberland estate that she had helped the family accumulate and that she may need to maintain the lifestyle to which she had grown accustomed.

**Survivor's ability.**--The survivor's ability and willingness to reduce the size of his (her) estate is a

key factor. The spouses' goals with respect to the welfare of the children must be compatible.

**Example 6.3.** Assume the same facts as before, but now the \$600,000 bequest to the children is put into a nonmarital trust from which the wife has the income for life. She has access to the same level of income as before. If desired, a clause can be included for invasion of trust principal subject to an ascertainable standard of living (see chapter 10 on "The Role of Trusts").

The spouse's ability and willingness to adjust the size of his (her) estate must be considered. In example 6.1, the wife's credit will be lost if she dies first, because she owns no assets. This situation can be remedied easily with a gift of \$600,000, which balances the two estates, permits use of both credits, and saves \$235,000 in taxes after each transfer. This remedy works if the credit is used by the first spouse to die by putting the assets in a nonmarital trust, or by giving it outright to the children. Spousal trust is essential--as discussed above--for this procedure to work.

To summarize the optimum marital deduction strategy: (1) it must be used in conjunction with the available unified credits, (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, a direct transfer to the surviving spouse, or by trust for his (her) benefit (see chapter 10). In any case, the transfer will usually 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 timberland that I own in Laidback County, State (legal description)."

**Example 6.4.** Assuming the same facts as in example 6.1, but specifying that the bequest includes zone IV mature timber and zone III

maturing timber (see chapter 2, for a discussion of timber zones), will provide liquidity for the surviving spouse's immediate needs. Alternatively, if the surviving spouse's needs for liquidity can be met from his (her) own resources, the bequest can be of zone I premerchtable timber and zone II young timber, both of which are rapidly appreciating assets.

**Money.--**This is known as a "pecuniary bequest," or a gift of money: "I give my husband \$600,000." That statement alone does not necessarily make it so, however. The resources have to be in the estate to generate the cash.

**Example 6.5.** Assume the same acreage as in example 6.4, but now the land and timber stands in zones I through IV are assumed to be distributed as follows: bare land equals \$300,000, which is equally distributed among the zones; zone I--premerchtable timber only, \$90,000; zone II--young growth of 30 cords per acre, \$210,000; zone III--young sawtimber, \$600,000; and zone IV--mature sawtimber, \$900,000; for a total of \$1,800,000 in timber and \$2,100,000 total value. This situation lets the total value increase reflect the potential value for the property. The acreage is equally divided into 250 acres per zone (which are handled as management units). The timber stands are as follows: the 8- to 10-year-old pine plantations in zone I are valued at \$360 per acre; pine pulpwood in zone II is valued at \$840 per acre (\$28 per cord); the small sawtimber in zone III is valued at \$2,400 per acre and is predominately chip-n-saw saw-logs; and the mature sawtimber in zone IV is valued at \$3,600 per acre because it is primarily high quality sawtimber. The bequest can include the acreage in zone IV, which will provide sufficient timber that can be sold relatively soon to generate the necessary cash.

**Fractional share.--The** owner can give a straight fractional share; that is, "I give one-half of my residual estate, outright, to my wife." The "net estate," technically known as the residual estate, is what remains after payment of debts, administrative expenses, specific bequests, and other charges.

**Example 6.6.** Assume the same facts as in example 6.5. The timberland portion of the bequest would thus amount to \$1,050,000, if the expenses, other bequests, and charges are paid from other liquid resources. This creates an immediate tax bill of \$173,500, which could have been deferred.

## Formula Marital Deduction Bequests

Other things being equal, the preferable approach would be to use a formula marital deduction bequest that sets aside the largest amount that can pass free of the Federal estate tax by way of the unified credit. This circumvents the problems generated when the bequest amounts have appreciated (depreciated in some cases, but rarely for timber) into an unanticipated tax situation. There are three basic formula clauses that are normally used.

**Pecuniary.** --The pecuniary marital deduction formula is easy to express and may offer greater opportunity for post mortem planning. The bequest can be made outright or in a marital deduction trust (see chapter 10). It directs that the amount to the marital share for the surviving spouse be the sum that minimizes the Federal estate tax payable. The bequest can be made outright or in trust. The residual share corresponding to the exemption equivalent and Federal credit for State death taxes can be disposed of outright or in a nonmarital trust (see chapter 10).

**Example 6.7.** Assume the same facts as in example 6.4. The pecuniary marital deduction share can include the timber from zones III and IV in order to provide liquidity. The residual share can include timber in zones I and II. 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 \$600,000 in the marital share can be consumed or gifted to reduce the second spouse's estate value.

**Unified Credit.** --The pecuniary unified credit formula (see chapter 10) is similar to the pecuniary marital deduction formula. It directs that an amount equal to the exemption equivalent, plus Federal credit 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 can also be outright or in trust. The results are similar to example 6.7 with respect to appreciation and liquidity.

### **Fractional Residuary Marital Deduction Formula.**

--This 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 only be determined after a final accounting by the executor--appreciation of estate assets is shared by the spouse and other beneficiaries, and this may be a desirable outcome in terms of family relationships even if it costs some additional tax.

## The Choice of Marital Deduction Formula

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

**Timber Assets.** --The treatment should be dictated by the landowner's goals as expressed in the timber 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 timber management plan into the overall estate plan can be facilitated if the timber 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 are usually 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 in that they are appreciating assets that respond 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 only periodic income is usually available, and illiquidity. The appreciation, moreover, will vary with market fluctuations 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 insure both 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 11).

**Personal Effects.** --Special attention should be given to their treatment, including value, when using the marital deduction formulas. Many family heirlooms are difficult to value and difficult to divide. The decedent and heirs often have particular attachments to

certain effects 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. The opportunity for a disclaimer provides 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 in other analyses. State death taxes often do not conform to the Federal estate tax model, and they can upset plans if not incorporated (see chapter 19).

## 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. Adjustments may not have kept pace with fast-moving events. Sometimes the decedent was merely careless or neglectful, and at death it's too late to change his (her) plan for disposing of property. Nevertheless, the heirs or legatees can often make certain changes in the plan of disposition through disclaimers, settlements, and the election to take against the will.

#### DISCLAIMERS

No one is forced to take what is due to him (her) under another person's will or by virtue of the laws of inheritance in the absence of a will. The bequest or legacy can be disclaimed. A disclaimer 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 effectively utilized to realize certain post mortem estate planning benefits that were not established prior to the decedent's death. 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. 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

Section 2518 of the IRC provides a single set of definitive rules for disclaimers for purposes of the estate, gift, and generation-skipping transfer taxes. To be effective, a disclaimer must be qualified.

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 day on which the transfer is made, or 9 months after the beneficiary becomes 21 years old.

- (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 without any direction on the part of the disclaimant. However, a 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.

**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. However, if there is a possibility that a disclaimer might be a useful post mortem 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 one who is going to disclaim. As noted above, the disclaimant cannot disclaim in favor of anyone of his (her) choice; all that can be done is a refusal 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. This could result in the beneficiaries of the surviving spouse receiving somewhat less than they might otherwise receive. In such a situation, the surviving spouse might wish 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 (that is,

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. 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 would all have to be considered.

### **Disclaimer 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. Internal Revenue Code 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**

Internal Revenue Code Section 2055(a) allows a deduction for a charitable transfer resulting from a disclaimer. For example, if a decedent's will provides that a charity would 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. If the contest or settlement is bona fide and at arm's length, the courts have held that no gift results.

## **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." 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.

# Chapter 8

## Gifts of Forestry Assets

### OVERVIEW

Estate planning frequently focuses on the transfer of property at death; however, 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. Stated another way, do not give away money or timberland that someday might be needed. Many gifting objectives are personal and do not involve tax saving, but they are just as, or perhaps more important than tax and financial considerations. However, careful attention to the tax rules permits the donor to stretch the benefits of his (her) gifting program.

### Some Reasons for Gifts

The foremost 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. Other beneficial effects that follow as a result of gifting are discussed in chapters 6 (“Use of the Marital Deduction in Estate Planning”) and 10 (“Role of Trusts”). Gifts to the adult children, especially of timberland, may help promote a sense of financial maturity in the donees and may provide the motivation for them to learn the business of managing the tree farm. Thus, the donor can see the responsibilities for managing a going concern transferred to the next generation with efficiency and effectiveness. It follows that the donor will gain a general feeling of satisfaction in seeing the timberland used and enjoyed. The process can assist the donees’ personal growth and, properly done, influence their behavior in favorable directions.

Gifts from senior family members who are in higher income tax brackets can improve the total family income tax burden by moving income-producing property into the hands of family members who are in lower tax brackets. Charitable gifts provide an income tax benefit while at the same time benefiting organizations that are personally important to the donor—churches, colleges, museums, and others. Gifting reduces (thins) the size of the donor’s gross estate and, in so doing, reduces both Federal and State death taxes. This also lowers estate settlement costs and avoids the delays and fees of the probate process with respect to the property gifted.

In some cases, the transfers can put the property out of reach of creditors.

Because of the power of gifting to reshape the donor’s estate, a program of gifting should be pursued cautiously because there are also disadvantages. Perhaps the most important is the loss of control. Thus, important business entities and key parcels of timberland may not be the best candidates for a gift. Gifts of income-producing assets reduce the donor’s income. A gift also transfers the donor’s basis to the donee, with possibly adverse income tax implications that would not be the case with testamentary transfers. Additionally, special use valuation (see chapter 13) is not available for lifetime gifts. Most of these points will be discussed more fully in the following sections of this chapter.

### GIFTING TAX CONSIDERATIONS

Any transfer of property or an interest in property, without adequate and full consideration in money or in kind, may involve a gift. The goal of gift and estate tax minimization has been made more difficult by recent changes in the tax laws. For example, Clifford and spousal remainder trusts can no longer be used as effective income-splitting devices. These short-term trusts with reversionary interests of income or principal were formerly used to shift income from the grantor to beneficiaries in lower tax brackets. Such income is now taxed to the grantor, effectively nullifying the benefit of these types of trusts. The so-called “kiddie tax” affects gifts to children under age 14 because their unearned income over \$1,100 per year is taxed at the parent’s top rate. Children 14 years and older with unearned income of \$550 or more are taxed at their own rate. This provides a considerable incentive to increase an older child’s income with income-producing gifts.

### Incomplete Gifts

If a donor retains an interest in or power over the property gifted, it results in the gift being incomplete. A complete 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.

Gifts with no strings attached are complete gifts. Incomplete gifts are more likely to occur in transfers to trusts than in outright transfers (see chapter 10 on trusts). 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 tree farm 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 as being complete, but its value has been reduced, and it is not eligible for the annual \$10,000 exclusion.

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 will be avoided on the value of the gift property and the gift taxes paid, 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) will treat the gift of underlying land with retention of the 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 held that the entire value of forest land given to an individual by a donor who reserved for 10 years all timber rights, 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 U.S. Fourth Circuit Court of Appeals has upheld the IRS position. The court held that under South Carolina law, when the 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 that the transfer to the corporation was not for an adequate and full consideration, the timberland was includable in her gross estate as a gift with a retained life estate (*Estate of Graham v. United States*, U.S. Court of Appeals, Fourth Circuit, No. 83-1068, Sept. 30, 1983).

## Gift Tax Rates, Credits, and Exclusions

The unified gift and estate tax transfer schedule applies to all gifts. As discussed in chapter 3, a single rate schedule exists with respect to both lifetime gifts and estates of decedents. The marginal tax rate begins at 37 percent of the taxable amount in excess of \$600,000. The top rate following the passage of the Revenue Reconciliation Act of 1993 is 55 percent on gifts and estates in excess of \$3 million (see table 3.1). The amount of gift tax payable in any calendar year is calculated by taking the cumulative lifetime taxable transfers and applying the unified transfer tax schedule. The tax on previous transfers is then subtracted from this amount, as is whatever has not previously been used of the \$192,800 unified gift and estate tax credit.

Internal Revenue Code (IRC) Section 2504(c) sets a 3-year statute of limitations for revaluation of lifetime gifts for gift tax purposes. It does not, however, bar the revaluation of lifetime gifts for estate tax purposes. Thus, a gift of timberland that does not have a readily determinable market value should be supported by a qualified appraisal to establish its fair market value (see chapter 4 for a detailed discussion of timberland valuation).

**Annual Exclusion.**--The annual exclusion permits the first \$10,000 in gifts, based on fair market value, to each donee (other than the donor's spouse) during each calendar year to be transferred tax free. The gift must be of a present interest; that is, it cannot comprise property or a right that cannot be utilized until some future date by the donee.

**Example 8.1.** Parents have four adult, married children. One parent, in this case the father, owns 2,000 acres of timberland in fee simple, which has an average value of \$1,000 per acre. The father (donor) can give each child (donee) \$10,000 in value each year. That is, he could give each child either 10 acres or a fractional, undivided joint interest in the timberland (see chapter 15) worth \$10,000 each, for a total of \$40,000 per year for the family. He could also give each child's spouse a similar 10 acres or \$10,000 interest in the timberland each year. This could be transferred as 20 acres or \$20,000 in joint family ownership to each child and spouse for a total annual family transfer of \$80,000.

As long as the donor makes the gift outright, the annual exclusion should not present a problem. However, with timberland, a qualified appraisal is necessary to verify the fair market value of the transfer.



In addition to the annual gift tax exclusion of \$10,000, there is an unlimited gift tax exclusion for qualifying payments of tuition and medical care. The deduction for tuition is limited to direct tuition costs, and the payment must be paid directly to the institution. The deduction for medical costs is for those unreimbursed by insurance as defined in IRC Section 213(d).

**Marital Deduction.** --The marital gift tax deduction is unlimited. For gift transfers to a spouse to qualify, the following requirements must be satisfied: the man and woman must be married at the time the gift is made, the donor spouse must be a U.S. citizen or resident, the donee spouse must be a U.S. citizen, and the gift cannot be a “nondeductible” terminal interest except for QTIP’s (see chapter 6 for a discussion of QTIP’s and terminal interests).

Although an effective planning tool in the right situation, the question remains as to what extent should the unlimited gift tax marital deduction be used? A lifetime transfer saves estate administrative expenses and probate costs for the donor spouse who dies first and it may permit full utilization of the unified credit if the other spouse were to die first. The QTIP election (see chapter 6) can be utilized if the donor feels that it is necessary to insure that the children ultimately receive the property. These decisions should be carefully analyzed with expert counsel and with the family’s goals fully in mind.

**Reporting Procedures.** --A Form 709 gift tax return (see appendix) is required for transfers of property greater than \$10,000 in fair market value and for split gifts (see below), regardless of value. Returns are due on April 15 with the Federal income tax returns for the tax year, or as extended.

**Other Considerations.** --Approximately one-fourth of the States have a gift tax on the transfer of property (see chapter 19). These provisions, if applicable, should be considered.

## Split Gifts

A married person who makes a gift to a child or any other person can treat that transfer as though one-half had been made by him (her) and one-half by his (her) spouse, if the spouse agrees. The gift is split for the purposes of computing the gift tax. Thus, the gift is taxed at a lower rate than if the transfer had been a single gift by one spouse. The \$10,000 annual exclusion and unified credit 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 mother (assetless spouse) agrees to make a split gift to the children. Each child will now receive a split gift of either **\$20,000** in undivided value or 20 acres. This can be increased to \$40,000 or 40 acres by making split gifts to the child and his (her) spouse. In that case, the total transfer for four children and their spouses would be \$160,000. A practical way to make the transfer would simply be to draft a deed for each family member for 40 acres in joint ownership.

Split spousal gifts are allowed only if: (1) each spouse is a citizen of the United States at the time the gift is made, (2) the parties are married at the time, and (3) both spouses agree to split all their gifts for the calendar year.

## BASIC GIFTING STRATEGIES

In this section, attention is focused on the question of the economic impact of giving an asset; the effective use of the unified credit, annual exclusion, marital deduction, and gift-splitting; and whether cash, or its equivalent should be the gift property. Timberland is emphasized, but other assets usually found in timbered estates are included.

### What Type of Property to Give

Choosing the right property for a gift is an important part of the gift plan. A gift may be of personal property--art, cash, business interests, securities (stock), personal effects, cars, and other tangible assets. It could be real estate--rental property, timberland, timber and hunting leases, personal residences, easements, or other rights in real property. Or, the gift could be of life insurance--cash value, cash refunds, or other benefits associated with the policy. Considerations in selecting gifts should, of course, be meshed with the overall estate planning goals.

There 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 a low gift tax cost but a high potential estate tax cost. Appreciating assets, such as timberland in zones I and II, fit this category (see figure 2.4 and the trust example in chapter 10). Timberland with high growth potential is a good candidate for gifts because it is likely to become an estate tax problem for the donor if held.

**Appreciated Property.** --Timberland often fits into the appreciated property category. Assume that a donor is in the 32-percent marginal income tax bracket--28 percent Federal and 4 percent State. If he (she) sells a property for \$10,000 net gain, the income tax will be \$3,200. However, if the donor gives the property to a son or daughter (older than 14) who is in the 15-percent marginal income tax bracket, the tax on the sale of the same property by the donee would be only \$1,500. This transfer should also be compared with a gift of cash while carrying the timberland through the estate for a stepped-up basis.

**High-yield Assets.** --Senior family members in the new 36.0- or 39.6-percent brackets may consider transferring high income-producing assets to children (over age 14) who are just getting started in their careers and who are currently in a low marginal tax bracket. Alternatively, a retired parent in the 15- or 28-percent bracket should consider gifts to children of low income-producing assets with good growth potential, such as rapidly appreciating young timber stands.

**Keeper Assets.** --Timberland is often low-basis property that will remain in the family. Many times senior family members who worry about control of their tree farm will consider taking the timber income and parting with the land. If it will cause future estate problems, the donor could harvest the mature timber and transfer the cutover, bare land to the children. This transfer can be coupled with gifts of some of the liquid assets to cover the cost of reforestation. In such a case, it is important to make sure that the donees have the resources to handle the management costs and carrying charges associated with the property while it is unproductive.

**Problem Property.** --If timber property will cause problems for the owner's estate executor because it is hard to divide, value, or sell, the owner could give the property during his (her) lifetime. Sometimes the family home, the lake property, or the shore cottage will fit into this category. Art, antique guns and clocks, and jewelry also fit into this mold.

**Jointly Held Property.** --If timberland 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 hold timberland 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.** --In order to keep life insurance proceeds out of the decedent's estate, it may be beneficial to transfer ownership of the policy to a junior family member or to a life insurance trust (see chapter 11). The gift tax cost is based on the value of the policy, but it is likely to be lower than for other assets with approximately the same expected value at the decedent's death because of insurance's "tax-favored" status.

## Income Tax Basis

The 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 in the donor's hands. For this reason, highly appreciated property should often be held in order to receive a stepped-up basis on the death of the owner. This strategy, however, must be balanced with the further appreciation potential of the property.

## Installment Sales and Gifting of Installment Notes

A strategy of selling property to a son, daughter, or other related person with installment reporting of gain and periodic forgiveness of all or part of the payments as they come due should be used with considerable caution. This runs the risk of having the sale recharacterized as a gift. Because the payments under the installment contract are treated as income to the seller, a possible solution is to treat the payment as income and make gifts of cash to the children who then make the payments from an entirely separate account (see chapter 12).

## GIFTS TO MINORS

Gifts within families are the most common type of lifetime gifts, such as from parents to children and from grandparents to grandchildren. Many are gifts to minors that are made without much thought being given to the legal or tax consequences. As long as such gifts are small, there is generally no serious problem.

As gifts increase in value, however, the so-called "kiddie tax" has a major impact on minors under the age of 14 (see page 47). On the other hand, State law is often more concerned about protection of the minors' rights and the minors' legal capacity to own, manage, and sell property. Many States require guardians for minors who own 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 of real property, such as timberland. Vehicles, such as trusts, custodianships, and guardianships, are utilized for protecting minors' interests. These differ in a number of important respects and their advantages and disadvantages should be understood before embarking on a substantial gifting program involving minors.

Two pieces of legislation have been widely adopted that make the process of gifting to minors more uniform across State boundaries. The Uniform Gift to Minors Act (UGMA) and more recently the Uniform Transfer to Minors Act (UTMA) have made it easier and legally safer 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 need to be considered, especially where timberland is concerned. The Revenue Reconciliation Act of 1993 increased the spread between the lowest and highest noncorporate income tax bracket by more than 50 percent. This in turn has increased the motivation for tax shifting. State income taxes also have to be considered.

**Example 8.3.** Assume that a parent who is in the 36-percent income tax bracket gives a child (over age 14) an interest in timberland that is under a long-term lease to a forest products company. The interest transferred provides an income of \$10,000 per year. The lease payment is treated as ordinary income for income tax purposes. If it is assumed that the child has enough additional unearned income from other sources to utilize his (her) \$550 standard deduction, the family has saved \$2,100 in income taxes [ $(\$10,000 \times .36)$  versus  $(\$10,000 \times .15)$ ].

However, the issue of parental obligations for legal support must be taken into account. A 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 Section 677. State law should be carefully considered with respect to the definition of support because expenses for private schools, a college education and, in some

cases, a graduate education may be considered as required for 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 could exercise over his (her) own property. These laws permit all types of property to be transferred, including timberland. The custodian can enter into business transactions that are required for managing 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 is usually 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 may be included in the donor's estate if the donor is the custodian and dies before the child reaches the age of majority. Therefore, it is *not* a good idea for the donor to also serve as custodian and risk having the assets included in his (her) estate, especially if the value is large. Similar problems exist with regard to the donor's spouse serving as custodian. These problems suggest that a reliable aunt, uncle, or cousin would be a safer choice.

**Gift Tax.**--Gifts under the UGMA and UTMA qualify for the annual gift tax exclusion of \$10,000 (\$20,000 for split gifts). However, the parent-donors 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. He (she) has fiduciary responsibilities similar to those of a trustee; however, the guardian does not hold legal title to the property. The guardian can be the recipient of gifts to 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 also legally obligated for his (her) support. The \$10,000 annual lease income would continue to be taxed at the parent's

36-percent marginal tax rate, even though it is now the property of the child, if used for the child's support. The portion (if any) not used for the child's support, but rather for his (her) benefit, 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 that are discussed below on pages 52 and 53.

A guardianship provides the greatest protection for the child's property rights. This includes bonding, accounting, and court supervision. The price for 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 terminations at majority, which may be earlier than what 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 larger gifts. The general applicability of trusts as an estate planning tool is addressed in chapter 10. Certain specific issues related to gifts to minors will be discussed here. The grantor has considerable freedom to design a trust instrument that meets his (her) objectives. It 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 successor), specify when and how the principal will be distributed, and fulfill other functions discussed in chapter 10. If substantial gifts are involved, this is probably the most effective method of handling a gift transfer to minors, assuming that the size of the gift warrants the expense of setting up and operating a trust.

Two basic types of trusts are in most common use as instruments for making gifts to minors. Trusts written to conform to the provisions of IRC Section 2503(b) make the annual gift tax exclusion possible because the transfer will be a gift of a present interest. This type of trust requires the current distribution of income to the minor but does not require distribution of the principal when the minor reaches majority. Trusts written in accordance with IRC Section 2503(c) also insure the availability of the annual gift tax exclusion on gift transfers for the

benefit of minors. Current distribution of income is not required, but the distribution of the principal and income is required when the minor reaches majority--or sooner if specified in the trust instrument. The annual exclusion will additionally be available if the income "may" be used by the beneficiary before he (she) reaches age 21, with the remaining principal paid to him (her) at age 21. If the minor dies before reaching age 21, it will be paid to his (her) estate (*Gall*, CA-5 75-USTC ¶ 13,107, 521 F2d (1975), aff'g DC Tex., 75-1 USTC ¶ 13,067). With these types of trusts, the income portion is considered as a gift of a present interest and the principal portion as a gift of a future interest. The income tax treatment for the beneficiary is as discussed above.

A trust written under the provisions of IRC Section 2503(c) is a separate taxable entity. The income tax treatment of trusts is discussed in chapter JO. The trust property will generally 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 qualify for the annual gift tax exclusion and also to make practical sense for management of property such as timberland. A qualified estate planner should be consulted.

### GIFTS WITHIN 3 YEARS OF DEATH

The value of gifts made within 3 years of the donor's death is generally not includable in his (her) gross estate. Such gifts are valued on the effective date of transfer, and the appreciation in value after that date is not subject to the estate transfer tax.

There are certain exceptions to this rule, however, which apply whether a gift tax return is required or not. The value of a life insurance policy transferred by the decedent within 3 years of death will be included in the gross estate. In addition, all gift transfers within 3 years of death will be included in the calculation of estate value for purposes of determining the estate's qualification for special use valuation under IRC Section 2032A (see chapter 13), deferral and extension of tax payments under IRC Section 6166 (see chapter 14), and qualifications for special stock redemption (IRC Section 303). Such gift transfers made within 3 years of death are not effective for 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.

In spite of these few restrictions, there are still 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 young plantations in zones I and II (see discussion of timber zones in chapter 2), are good candidates for gifts. Similarly, subsequent income generated from the gift is not includable in the donor's estate although the gift tax paid on the transfer is included. 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 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 earlier, the gift does not get a stepped-up basis as does a testamentary transfer. This is particularly disadvantageous for timberland because timber is a long-term investment. The basis for most timber assets held for long periods of time is low.

## CHARITABLE GIFTS

### Overview

With the peace of mind that comes from knowing that one's spouse and children will be adequately provided for, a plan for charitable giving of additional assets may bring great personal satisfaction. A donor can benefit both 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 overall tax rate (that is, the sum of Federal, State, and local marginal rates, as adjusted).

**Fulfills Dreams.** --Charitable gifts can help fulfill dreams of things that the donor would like to have done to help others, given different circumstances. For example, a scholarship could be provided for a talented young person to help him (her) achieve things not able to be done directly.

**Sets Example.** --Giving sets a powerful example of generosity and humanitarian concern for others--a message of incentive and motivation to a generation with sufficient wealth for survival. It also refutes the mind set that implies, "I have mine and I don't care about you!"

**Uses Resources Efficiently.** --Gifts permit efficient uses of resources. For example, churches and scholarships provide large benefits for the community and for society by combining voluntary labor and a rapid turnover of resources. The gift enables the charity to leverage its resources.

**Permits Choice.** --Gifts permit a choice of charitable opportunities, such as churches, forestry research, youth programs and community efforts. These may be combined in a number of ways that meet the donor's objectives.

**Satisfaction.** --Gifts should be viewed as a source of satisfaction rather than a cost. The donor should feel good because he (she) has contributed to the betterment of one or more persons or organizations that benefit the community.

### Charitable Income Tax Deduction

Taxpayers can deduct amounts contributed to religious, charitable, educational, scientific, and other organizations for income tax purposes. The 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 and their effects on deductions. These categories include: (1) public charities--such as churches, universities, hospitals, and foundations that have received considerable public support; (2) semipublic charities--such as veterans organizations, nonprofit cemetery associations, and others that do not fit into 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 subdivisions of government are automatically viewed as charitable, but private charitable organizations must meet the requirements of Section 501(c)(3) of the IRC and have an exemption letter from the IRS to prove their status in order to assure a tax deductible contribution.

The percentage limitations on charitable contribution deductions are based on the charitable 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." The donor's contribution base is defined as his (her) adjusted gross income without regard to any net operating loss carryback.

A 50-percent limitation on charitable contribution deductions applies jointly to so-called "50-percent"

charities, which include a number of organizational categories, both public and private. It is applied to public charities first, then to private charities, and any contributions in excess are carried over for 5 succeeding taxable years. There is a 30-percent limitation on deduction of contributions to private charities classified as so-called "30-percent" charities, as well as 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 is limited to 20 percent of the donor's contribution base. There is also 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 these various categories.

*Valuation of the 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. However, for large gifts of real estate or timber property a qualified appraisal must be obtained and a summary must be attached to the tax return (Section B, Form 8283) if the value of the property exceeds \$5,000 (\$10,000 for nonpublicly traded property). The appraisal must be made within 60 days prior to the date of the gifts. The appraiser must be qualified to make appraisals of the type of property being gifted. For example, timberland should be appraised by a person who meets the federal appraisal standards. The appraiser must sign the appraisal 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 gains 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. That is, 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. For real estate, including timberland, the donor is entitled to a deduction based on the property's fair market value

on the date of the contribution. The deduction is generally 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 is 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.

However, there is also a special rule on contributions of appreciated property that permit 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 election decision should be based on the amount of the appreciation (timberland often has a very low or zero 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 alternative minimum tax (AMT) provision of the Federal income tax. The 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. In addition to the income tax deduction discussed above, the estate tax deduction depends on the marginal tax rate. At the estate's taxable threshold (that is, just over \$600,000 in taxable estate value) the saving would be 37 percent of the value of the charitable contribution. When the value of the taxable estate exceeds \$3 million, the donor saves 55 percent of the value of the contribution. If the transfer is a testamentary bequest or includable in the donor's estate by virtue of a retained interest, only the estate tax deduction will be available.

## **Gifts with Retained Interests-- Charitable Remainders**

A timberland owner may be thinking of giving a particular property to a charity, but he (she) may feel that the income from the property is needed for the present time. The transfer could take effect at death, but there may be a spouse or other family member who would need the benefit of the income value after the donor is gone. For example, there are many parents who own woodlands in rural, often remote areas of the country with children who are professionals and live in distant cities, and who often have little interest in the tree farm. However, the children

may feel that they need the income for educating their children or for some other reason.

Such a landowner can make a present gift to a charity of a future interest. This is 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 perhaps on the death of other persons as well. The donor of the gift gets a current income tax deduction based on the present value of the remainder interest. There are, of course, some strict limitations.

The value of the remainder interest is deductible for Federal gift tax and income 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," 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 noncharitable beneficiaries only if the trust qualifies as an annuity trust or a unitrust under the IRC. The annuity trust provides a "fixed annuity payment" to the income beneficiaries. A unitrust provides a "variable annuity payment" based on a percentage of the trust's earnings. Both 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 persons 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 timberland, the payments may fluctuate with the cyclical nature of the 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 terms of the grantor's will under specified terms and conditions [Treasury Regulation § 1.664-3(b)] and (Revenue Ruling 74-149). On the other hand, 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. In fact, 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 merits 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 the deficit in previous payment amounts is made up [IRC Section 664(d)(3)].

**Tax Consequences.** --The remainder interest under an annuity trust for tax purposes 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 individual. The present values are computed using the IRS tables in IRC Section 7520 and are based on a floating interest rate--120 percent of the midterm applicable Federal rate. Examples of the procedure can be found in IRS publication 1458.

The annuity trust and the unitrust are exempt from Federal income taxes except for unrelated business taxable income. The distributions to trust beneficiaries are taxed as ordinary income first, and then as capital gains to the extent of the trust's undistributed capital gains.

For estate tax purposes, the trust property's value will be includable in the grantor's estate if he (she) is the sole beneficiary.

**Pooled Income Fund.**--This is an IRS-designed vehicle for charitable contributions that meets a donor's needs and provides him (her) with a tax deduction. It operates 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 are commingled. The 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. It reduces death tax liability; however, there is 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. However, the IRC makes an exception for the gift of a personal residence or farm [IRC Section 170(f)(3)(B)]. Under these circumstances, a donor can contribute the property to charity but reserve the right to live on it or use it for the rest of his (her) life and for that 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 and improvements used by the donor or tenant to produce crops, fruits, or other agricultural products or livestock or poultry [Regulation §1.170A-7(f)(4)]. The regulation does not explicitly include or exclude a tree farm. But if a taxpayer is considering using this provision of the IRC for a tree farm, it would be prudent to obtain a letter ruling (see page 33) 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 any 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 entire interest of the donor in the property [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 the

United States in perpetuity. Special rules apply to easements and remainder interests granted for conservation purposes.

Gifts of partial interests in real estate generally do not qualify for a charitable contribution deduction; however, a qualified conservation contribution 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 real property. The term “conservation purpose” is defined to include any one (or more) of four objectives: (1) the preservation of land areas for outdoor recreation by the general public 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 preservation of open space, including farmland and forest land, where such preservation (a) is for the scenic enjoyment of the general public and will yield a significant public benefit or (b) is pursuant to a clearly delineated Federal, State or local conservation policy and will yield a significant public benefit, and (4) the preservation of a historically important land area or certified historic structure.

The conservation purpose must be protected in perpetuity. Qualified organizations are limited to government and publicly supported charities or organizations that they control. The value of the conservation easement is based on the sales of similar easements to the government 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 [Regulation §1.170A-14(h)(3)]. 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.

**Example 8.5.** Talloak owns a 200-acre parcel of timberland in the path of a suburban leap frog development. The property has been in the family since the original land grant from the King, and it is the owner’s objective to keep the property in the family and in timber production. The market value of the property for timberland is \$300,000, including the current growing stock which has been well managed for timber and wildlife. The fair market value in the “highest and best use” in 1993 had risen to \$900,000. Talloak gave the USDA



Forest Service a permanent conservation easement subject to the restrictions that the property would be managed on a sustained-yield basis, that no more than 20 percent of the forest could be harvested in a 5-year period, and that it would be promptly regenerated within 2 years. The \$400,000 charitable deduction is limited by the income tax contribution rules discussed above. The income tax deduction is limited to 30 percent of adjusted gross income because it is appreciated property given to a public charity. Since Talloak's adjusted gross income is \$200,000, the current income tax deduction is \$60,000 ( $\$200,000 \times 30$  percent). With a 5-year carry-over for excess contributions, Talloak's adjusted gross income is expected to increase sufficiently to fully absorb the deduction over this period. The estate's value is also reduced by \$400,000 due to the restriction. The appraisal was made by a qualified consulting forestry company that specializes in forest appraisals.

### Examples of Charitable Giving

The following are recent actual case examples, with the persons' names changed.<sup>7</sup>

#### **Example 8.6.** Case 1--A Gift of Timber.

Mr. Plen T. Trees, a bachelor in his mid-50's, was interested in a plan that would save taxes and pay him income for life.

He owned a stand of timber, deeded to him by his parents 20 years earlier, and now worth \$300,000 to \$350,000. He owned only the timber, not the land.

Working with his CPA and Linfield's development office, he established a charitable remainder trust with the timber. This made it possible for him: (1) to avoid the capital gain on the sale of the timber, (2) to obtain a charitable income tax deduction in the year of the gift, (3) receive an income for life, and (4) to save on estate taxes by reducing his taxable estate.

A unitrust was chosen because Mr. Trees wanted a vehicle that would keep up with inflation. A unitrust pays a fluctuating income based on the value of the assets in trust, revalued annually. As the trust assets increase/decrease in value, Mr. Trees receives a higher/lower income.

The specific unitrust is an "income only with makeup provisions" instrument. In periods when the trust assets do not earn enough to pay the agreed upon percentage, Mr. Trees receives the actual income earned. The balance will be "made up" and paid to him later in years when the trust earns more than the agreed upon percentage.

The results are that the trust sold the timber for \$330,000, neither Mr. Trees nor the trust had to recognize a capital gain on the sale, he was allowed a charitable income tax deduction in the year of the gift of \$34,000, and he began receiving an annual income equal to 12 percent (when the trust was established in 1988 interest rates were higher than currently) of the value of the trust, which will continue throughout his lifetime. At Mr. Tree's death, Linfield College will receive the trust principal that remains as a charitable gift and will set up an endowed scholarship fund in his name.

#### **Example 8.7.** Case 2--A Gift of Land and Timber.

Mr. Well D. Zerved, a recently retired businessman who had developed a very successful company, wanted to make a major contribution to the educational programs of Linfield College. He and his wife, ages 68 and 70, had several children and many grandchildren for whom they wished to provide in their estate plan. They had sufficient financial wealth from his work to leave substantial amounts for their heirs as well as their charitable interests.

Working with his attorney to determine which assets to use and the best way to make the contribution, Mr. Zerved established a charitable remainder unitrust and named Linfield College as the charitable remainderman. He funded the trust with a large tract of land, timber, and mineral rights that he had held for many years. The property would have been subject to a considerable capital gain if sold directly.

Since Mr. Zerved wanted to make sure that his wife was well provided for if he should predecease her, he chose a two-life trust that would make payments throughout both their lifetimes. Specifically, it is a unitrust with a "net income with makeup provision." The payout rate is set at 10 percent of the assets of the trust, revalued each year.

The results were that the property, appraised at \$550,000, was sold by the trust for a much higher price with no tax obligation. Mr. Zerved was allowed a charitable gift deduction of \$96,700 in the year of the gift, he avoided income tax on the sale of the appreciated value of the property, and

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<sup>7</sup>Prepared by Ms. Elizabeth Holden, Director of Planned Giving, Linfield College, McMinnville, OR, and used with permission.

he reduced the taxable value of the estate. Mr. and Mrs. Zerved are receiving an annual income, set at a payout rate of 10 percent, until the death of the survivor beneficiary. At that time, Linfield College will receive the proceeds of the trust and establish a named endowment as requested by Mr. Zerved at the time the trust was created.

**Example 8.8.** CASE 3--A Gift of Timber with Timberland Retained.

Mr. and Mrs. Juan A. Travel, farmers approaching retirement (ages 55 and 53), were interested in freeing themselves from some of their farm responsibilities. They wanted to retire, have their son take over the responsibility of running the farm, and have as much income as possible to do a little traveling.

They owned a tract of timber valued at approximately \$150,000 together with the land they farmed. It had such a low basis that they would have had to pay what seemed like an

enormous amount of capital gains tax if they sold it. Mr. Travel had heard about charitable trusts, so they came to Linfield College to find out more about this life income arrangement. Because they wanted to pass the land to their children when they died, they decided to retain the land, but give the timber to establish a charitable remainder trust.

The results were that in 1990 the trust sold the timber tax free to a buyer who logged and replanted the tract. The Travel's have a lifetime income from the two-life unitrust with an annual payout rate of 7.5 percent of the trust's assets, revalued annually. Because they avoided a capital gain tax, they had \$45,000 more invested for income than they would have had if they had sold the timber themselves. Their children will receive the reforested land with growing timber when they die. Linfield College will receive the principal in the trust to establish a scholarship fund in the Travel's memory.

# Chapter 9

## Generation-skipping Transfers

A detailed discussion of generation-skipping transfers and the associated generation-skipping tax imposed by chapter 13 of the Internal Revenue Code (IRC) is beyond the scope of this book. The procedures involved are complex in nature and often hazardous to implement.

Nevertheless, generation-skipping transfers, if properly planned, can be used to provide income free of Federal estate and gift taxes to one or more generations of direct heirs. The property itself eventually passes to a person or persons two or more generations down the line. The forest estate planner should therefore be alert to the benefits of generation-skipping transfers while at the same time understanding the disadvantages.

### GENERAL PROVISIONS

Every individual has a \$1 million generation-skipping transfer exemption which he (she) can allocate during life by gift or at death by will to any number of generation-skipping transfers. An allocation, once made, is irrevocable. Married couples can elect to split the use of the exemptions, thus raising the amount to \$2 million, much like the case of split gifts discussed in chapter 8.

The generation-skipping transfer tax is imposed at the time the property is eventually transferred. Unlike the estate and gift tax, which has a progressive rate structure, the generation-skipping tax is imposed at a flat rate equal to the maximum Federal estate tax rate in effect at the time of the eventual transfer--currently 55 percent plus a possible surtax.

A generation-skipping transfer involves use of a granted life estate that can either be held in trust or created outside of a trust. Life estates not held in trust are referred to as legal life estates. The disclaimer provisions of Federal law discussed in chapter 7 apply for generation-skipping transfer purposes (see IRS Letter Rulings 8815034 and 8907028).

### Advantages

If the family goal is to preserve the woodland operation intact through more than one generation,

minimization of the estate tax in the estates of the children of the current generation is critical. Preserving the operating property for the lifetime of the children is consistent with such a family goal, and thus a generation-skipping transfer may be an ideal arrangement.

**Example 9.1.** A grandparent (A) might leave by will a tract of timber property valued at \$500,000 to his child (C) for life, with a remainder interest to a grandchild (G). C, the life tenant, would be entitled to the income from the property for life. At C's death, title to the property would pass to G. Under current law, an exemption from Federal tax of \$1 million per transferor, as discussed above, is provided. This means that the property in question would be subject to Federal estate tax in the estate of A but not again until the death of G. At G's death, the transfer would be subject to a flat rate of 55 percent under current law. The same rule would apply if the transfer by A had been made by deed during his lifetime rather than by will at his death, with the normal \$1 million exemption.

Strategic use of the \$1 million exemption will permit particularly large sums to escape taxation. Assets with the greatest potential for appreciation should be used to fund generation-skipping transfers.

### Disadvantages

A number of disadvantages apply to generation-skipping transfers. In specific instances, these may offset the potential benefits. A careful analysis of each particular situation is critical in order to avoid costly mistakes.

Special use valuation as discussed in chapter 13 applies only to generation-skipping transfer property as included in the transferor's gross estate, not to the property as included in the eventual transferee's estate. The same rule applies to the installment payment of estate tax under Section 6166 of the IRC as discussed in chapter 14. As mentioned above, the property will be taxed in the transferee's estate at the maximum rate then in effect, and without benefit of the unified credit. The credit for previously taxed property (see page 22) also is not allowed. With respect to life-time generation-skipping transfers, the \$10,000 gift tax

annual exclusion is not available if the transfer is not of a present interest. (See chapter 8 for a discussion of the annual exclusion.)

### **Special Problems with Timber Properties**

Problems may arise with legal life estates over the question of how far the life tenant can go with respect to certain actions involving the property in question. This is particularly important with timberland.

For example, what constitutes income from a timber property? Will harvesting be restricted to cutting only timber volumes equal to the growth that occurs

after creation of the life estate? Or can additional harvesting be done if part of a professional forest management plan? What rights do the life tenant have with respect to making changes on the property where an expenditure of funds would be needed to return the land to its previous condition? What about minerals? State law in many instances controls the answers to these questions. In some cases, however, depending on the State in question, there are no clear guidelines. For these reasons and more, a trust with carefully drafted powers for the trustee can provide a more flexible management structure than could a transfer outside of trust. (See chapter 10 for a more detailed discussion of trusts.)

# Chapter 10

## Role of Trusts

### OVERVIEW

A trust is an arrangement by which a person or entity called a trustee holds legal title to designated property in trust. The property in the trust is called the corpus, and it 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, controls on 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, might do for himself (herself) and some things that he (she) cannot do because of lack of skill, sickness, disability, distance from the timberland, or death. The ability of the trust to bridge the gap between life and death is one of its remarkable characteristics. A trust is recognized as a separate legal entity under both State and Federal law.

### BASIC CONSIDERATIONS

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

#### 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 as follows:

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

**Trustee.--This** is the person or entity who 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 cotrustees 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 (timber merchantable volume and young growth present at creation of the trust) 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 especially important as concerns timberland because of sometimes rapid changes in markets, new technology, and environmental regulations.

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

**Term.--The** length of the trust is the term. If a shorter period is not specified, a saving clause against perpetuities can provide that the trust will end no later than the period allowed by State law. State law generally limits a trust term to no more than 21 years longer than the death of the last surviving beneficiary named in the trust.

**Bond.--The** trust may specify that the trustee post a bond, but most trusts normally exempt the trustee from this requirement and 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, becomes incapable, or declines to serve.

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

#### Nontax Benefits

Nontax benefits can include professional management of financial and real property assets, including timberland. A trust can be designed to assure a timber

owner or beneficiaries designated by the owner of both income and protection from creditors. Trusts are frequently designed to benefit family members--such as spouses, minor children and grandchildren, and aged parents--during either the life of the grantor (living trusts) or after the grantor's death (testamentary trusts). *The* trust supplies the missing management and experience elements 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 insuring professional management of timberland and other assets and by freeing the grantor and/or beneficiaries from management details. A trust assures 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 later.

### Income Taxes

A trust can either be a separate taxable entity or a conduit for passing income to beneficiaries, who then report the income on their own returns, or both. Moreover, 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. The grantor is taxed on trust income only to the extent of income actually received, or income actually used for the support of someone that the grantor is legally obligated to support.

The Federal income tax saving benefits associated with trusts have been severely limited by recent tax reform changes. *The* rules with respect to short-term, income-splitting trusts--such as Clifford and spousal remainder trusts (see chapter 8)--have been changed so that the income from such trusts is now taxable to the grantor, thus removing them as an effective income-splitting device between grantor and beneficiary. Income from other types of trusts received by children under age 14 who are eligible to

be claimed as dependents on their parents' returns is taxed at the parents' rate on income in excess of \$1,100 per year. Both trust and estate Federal income tax rate schedules have been revised to lower the bracket thresholds far below those of other **noncorporate** taxpayers. Trusts must also now make estimated payments on income. The current income tax rules regarding estimated payments and distributions to beneficiaries may serve to increase the cost of trust administration. Generally, trusts must use a calendar year as their tax year. There still remain a number of ways for the 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 for trusts required to distribute all income currently and \$100 for others, is allowed. For the 1993 tax year, undistributed income is taxed at 15 percent on the first \$1,500, at 28 percent on amounts from \$1,500 to \$3,500, at 31 percent on income from \$3,500 to \$5,500, and at 36 percent on amounts over \$5,500. A 10-percent surtax produces an effective 39.6-percent rate on taxable income above \$7,500. These rate thresholds are indexed for inflation.

Deductions and credits for trusts are similar to those for individuals, with some important differences for timber. For example, trusts are not eligible for the reforestation amortization and investment tax credit. These expenditures must be capitalized and recovered when the timber is sold or otherwise disposed of. The opportunity to immediately deduct certain depreciable costs under Section 179 of the IRC also is not available to trusts. Other differences are covered in Section 642.

Generally, the conduit principle applies to income distributed under a simple trust. The income is reported by the trust on its tax return and is then allowed as a deduction to the extent distributed or required to be distributed. Beneficiaries are taxed on the income required to be distributed to them whether received or not. Thus, the trust works as a conduit for income passed through to the beneficiaries. The distributable net income (DNI) concept limits the distribution deduction allowed the trustee. It also limits the amount includable in the beneficiaries' gross income. Distributable net income is defined in IRC Section 643(a).

**Example 10.1.** A simple timber trust requires that all income be distributed currently to the life beneficiary. The trust has ordinary income in 1993 of \$18,000 from crop and hunting leases, expenses of \$750 chargeable to income, long-term capital gains of \$6,000 from timber sales, and \$2,250 in expenses chargeable to corpus.

The beneficiary would receive \$17,250 (\$18,000 minus \$750). The trust's DNI would be \$15,000 [\$18,000 - (\$750 + \$2,250)], which is the taxable amount to the beneficiary (capital gains are excludable from DNI). The trust's taxable income is \$5,700 [(\$18,000 ordinary income + \$6,000 capital gain) - [(\$300 exemption + \$3,000 expenses + \$15,000 DNI)]. The result is that the trust beneficiary gets deductions that would ordinarily be charged to trust principal.

Example 10.1 is for a simple trust. Complex trusts, which may accumulate income or distribute principal, in addition to distributing income, are much more intricate and beyond the scope of this discussion.

The income tax basis for property transferred to a trust by lifetime gift is the donor's basis increased by the gift tax on the unrealized appreciation. On the other hand, property transferred to a trust from a decedent that is includable in his (her) estate 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 is often the case with timberland. The stepped-up income tax basis for timber property that is valued in its current use under IRC Section 2032A (see chapter 13) is its special use value.

**Accumulated income.--There** may be 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 so permits. If the beneficiary's tax bracket is higher than that of the trust, the accumulation of income will produce an immediate tax saving. However, because the 28-percent tax bracket for trusts begins at \$1,500, the opportunity for this type of savings is 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 will be taxed as they would have been in the years the income was earned by the trust. A "short cut" method is now used for computing the tax, which is still quite complicated.

## Estate Taxes

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

If the grantor is willing to relinquish control of trust property forever, the property's value will not be included in his (her) estate. However, if the property is an insurance policy on the life of the grantor, he (she) must transfer it to the trust more than 3 years before death in order to be excluded from the estate. Most grantors are reluctant to give up control even if it means large estate tax savings. Furthermore, tax problems are often associated with living trusts when it is not clear how much control or benefit has been retained by the grantor. There are a number of guidelines in several sections of the IRC that should be observed if the desired outcome is to prevail for the heirs.

**Power.--The** power to revoke, alter, amend, or terminate a trust should be given up. If such powers are retained, they will result in the trust assets being included in the grantor's estate. Furthermore, the changes should be made more than 3 years before the expected 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, it will result in the property being included in the grantor's estate. For example, reserving the right to hunt and fish or the right to hunting lease income from timberland will have the effect of including the entire property in the decedent's estate. This rule also applies to voting rights associated with stock in a "controlled corporation" (see chapter 17), which may own timberland 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, it may be included in his (her) estate (IRC Section 2036).

**General Power of Appointment.--Retention** of control 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 to be 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 11). Transfers of any powers with respect to an insurance policy, within 3 years of death, will result in inclusion of the policy 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 exclusions available as there are beneficiaries for either the \$10,000 annual exclusion or the \$20,000 split gift tax exclusion (see chapter 8 and the trust example on page 66).

Transfers of nonincome-producing property to a trust can also pose a problem in connection with the annual exclusion. Timberland is generally 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 and that it is producing unrealized income in terms of volume 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 anytime to show current annual increments and a schedule of accumulating values.

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

## TYPES OF TRUSTS AND APPLICATIONS

Trusts are flexible tools in estate planning that generally provide one or more otherwise unavailable benefits. These include shielding the trust's assets from creditor's claims, accumulating funds for college tuition, and providing necessary financial support for children or retired parents. Income or estate tax savings, or both, may also be a goal, as well as the desire to avoid probate.

## Living Trusts

A living trust is created during the grantor's lifetime. It can be either revocable or irrevocable depending on the goals of the grantor.

**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. He (she) may pay gift tax upon establishment (see chapters 3 and 5), but the trust corpus is not includable in his (her) estate, and income is taxable to the beneficiaries as it is distributed annually. Other advantages of an irrevocable living trust include the possible saving of estate taxes in the grantor's estate and those of the life beneficiaries, providing protection for family assets, and perhaps saving income taxes for the family. Avoiding probate prevents public disclosure of the decedent's financial affairs, the size of the assets of the estate, and the listing of the beneficiaries and the property each received. With respect to timber, it eliminates the necessity of operating the tree farm as part of an estate while the estate is being settled. Probate fees and expenses are saved. Estate tax savings are achieved by keeping the trust assets, which may have appreciated considerably since the trust was established, out of the grantor's estate. This is accomplished 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 an incidence of ownership of a life insurance policy on his (her) life that names the trust as beneficiary, or not transferring ownership of the insurance policy on his (her) life within 3 years of death (IRC Sections 2042 and 2035)--all as discussed earlier.

The primary disadvantages of an irrevocable living trust are giving up control of the timber property and other assets placed in trust, and keeping a hands off posture forever. There are also, of course, the costs of distributing the trust corpus upon termination. Gift taxes will also be due if the transfer to a trust exceeds the \$10,000 (\$20,000 for split gifts) annual gift tax exclusion per beneficiary (donee) plus whatever unified credit equivalent is available.

**Revocable Living Trust.**--A revocable living trust may be changed or terminated by the grantor at any time. It may be funded or unfunded; it provides an



opportunity for the grantor to try certain provisions and make changes as needed to meet his (her) goals. Because it is revocable, there are essentially no tax savings associated with this type of trust. The income is taxable to the grantor. The fair market value of the trust assets are taxable in the grantor's estate. There is no gift tax, however.

The advantages of a revocable living trust include: (1) avoiding probate; (2) avoiding interruption of family income upon either the grantor's death or upon 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 timber properties, in two or more States by putting the title in trust and avoiding ancillary probate; (5) enabling a business or other enterprise, such as a tree farm, to continue operating; (6) relieving the grantor of an administrative burden, such as timber management; (7) having generally less accounting and administration 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 serving to bar 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; and (10) serving as an instrument to accept death benefits from employee plans and life insurance proceeds on the grantor's life. Thus, the revocable living trust has many advantages, but it is very important to have the instrument carefully drafted and coordinated with the grantor's will.

The disadvantages, as noted above, are that the income is taxable to the grantor and the trust's assets are includable in the grantor's estate. However, the trust becomes irrevocable on the grantor's death (unless terminated at that time) and then becomes eligible for tax advantages associated with irrevocable trusts. The trust may be established to avoid death taxes upon the death of the beneficiaries, although this procedure is subject to the generation-skipping tax (see chapter 9). The trust incurs the costs 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 is generally revocable but may be established to become irrevocable upon the grantor's disability. It provides supervised control and investment management if the grantor is

disabled or absent, but the income is taxable to the grantor, and the fair market value of the estate property is includable in his (her) estate. There is no gift tax liability. The standby trust is essentially designed for the contingency of the grantor becoming mentally or physically disabled, or having the inability to manage his (her) affairs for any reason. Its primary advantage is 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 disadvantages are that there are no income or estate tax savings and it may not be available under the law in some States.

**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 these occur over time--such as insurance payments, annuity checks, and similar receipts. 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 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 prime 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 prime beneficiary and are not 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's execution, kept separate, and incorporated by reference.

**Grantor Retained Interest Trust--**With the so-called 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 of such trusts are generally negligible. The trust income is taxable to the grantor. The value of the corpus is not taxable to the grantor's estate unless he (she) dies within the reserved income term (period). The gift tax that may be due on establishment of the trust depends on the value of the remainder interest at the time the trust is created.

The term of GRAT's and GRUT's 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 considering both mortality tables and actual life expectancy due to health and other factors.

Current rules substantially limit the use of GRIT's that provide transfers for the benefit of a family member. Family members are defined to include spouses, 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 and nephews or friends. There are special rules for the valuation of tangible **nondepreciable** property, especially undeveloped land that generates limited or uncertain income. It would seem that forest land would be included in this category. The valuation under IRC Section 2702(d) 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.

### Testamentary Trusts

Trusts created in accordance with the 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 are includable in his (her) estate, but there is no gift tax liability. Generally, a testamentary trust is utilized 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 utilized by successive generations, such as surviving spouse, then children, and then grandchildren. The generation-skipping transfer tax (see chapter 9) may become applicable upon final disposition of the property. The **nonmarital** credit trust is a good example of an estate tax-saving testamentary trust. Up to \$600,000 of the decedent's assets, including timber, could be put into trust at the decedent's death and qualify for the unified credit. The trust would then 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 will thus not be taxed in either the decedent's or the surviving spouse's estate and the corpus passes to the children or other second generation beneficiaries estate-tax-free.

**Example 10.2.** Greentree owned 1,200 acres of timberland--one-half was a 10-year-old plantation valued at \$600,000 and growing currently at 25 percent per year; the other half was mature timber valued at \$1,500,000. Assume that this constituted the net taxable estate for his spouse, two married children, and four grandchildren. None of the unified credit had been previously utilized.

When Greentree died, his will's marital deduction formula clause directed the \$600,000 exemption equivalent into the nonmarital-unified credit trust (see fig. 10.1 on the following page). This transfer was protected from estate tax by the unified credit of \$192,800. 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 if required, subject to an ascertainable standard of living. The executor funded this bequest with the plantation valued at \$600,000 so that its rapid appreciation would accumulate tax free for the children and their families.

The balance of the estate, \$1,500,000 in mature timber, went into a marital deduction trust for the surviving Greentree spouse. The estate tax was deferred by Greentree's marital deduction, and an additional \$600,000 will pass tax free to the children and their families at the spouse's death. In the meantime, the timber will be harvested and each family member will be given \$10,000 per year plus tuition while in college and **graduate** school. Because the surviving Greentree spouse has a life expectancy of 22 years and a yen for travel, these procedures are expected to thin the estate sufficiently to avoid significant tax problems at the second Greentree death.

### The Importance of Flexibility

Trusts are usually drafted to last for long periods of time, but many things change over the years that are difficult to anticipate in advance. With revocable trusts, these can be addressed by the grantor as required. With irrevocable trusts, however, it is necessary to build in flexibility so that the trustee has the power to respond to changed conditions in order to achieve the grantor's objectives. Psychologically, this is difficult to do for many grantors. Nevertheless,

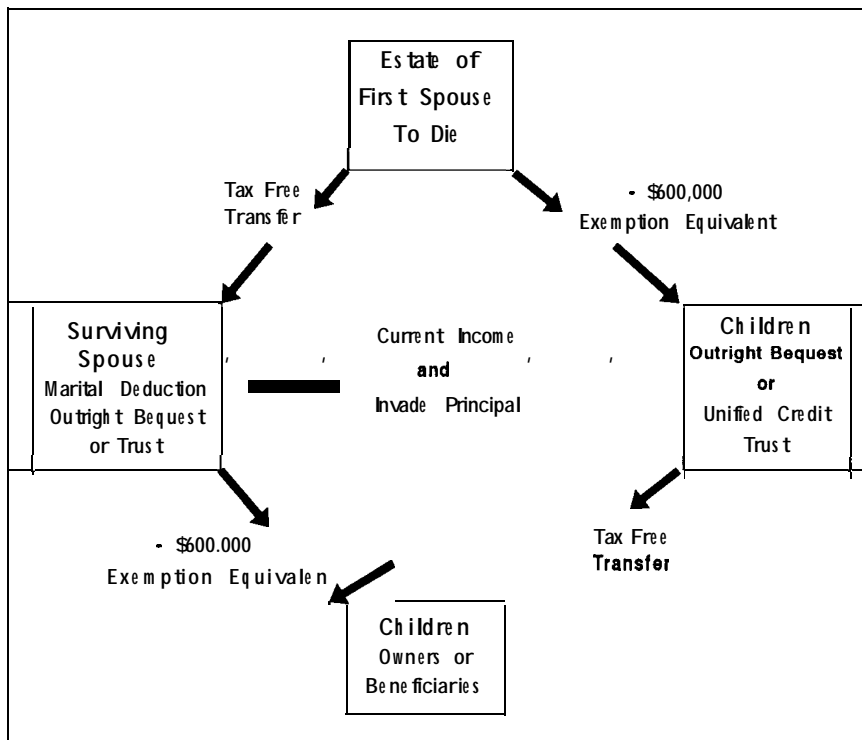


Figure 10.1-- *Intergenerational transfer of timber assets using the unified credit with either a marital deduction trust or with an outright bequest.*

there are a number of features that permit flexibility and safety for both the family and the trust assets.

**Income-sprinkling Clause.**-- This clause permits the trustee to act as a parental substitute by distributing income as needed or accumulating it 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. They should address the treatment of excess income and plans for distribution as the beneficiaries come of age. This can be done by a letter outside the trust instrument. In the case of timber assets, it can be done in the forest management plan. The grantor may wish to consider a separate trust for each sibling in order to avoid conflicts. Income-sprinkling clauses can also be utilized to provide surviving spouses with fixed minimum levels of income by giving the trustee the power to sprinkle the spouse with funds as needed. It is important that the grantor be distanced from the decision 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 accompanied by a cotrustee 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 IRS regulations, this may include education (including college), support in reasonable comfort, 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.**-- 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 generally exercisable only during 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 present interests. This in turn permits such gifts up to \$10,000 per donee (\$20,000 per donee for split gifts) to qualify for the annual gift tax exclusion (see chapter 8 for discussion of the exclusion).

*Other Provisions.*--Beneficiaries with disabilities can be provided for by defining "disability" and addressing 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 provisions might be considered (see Chapter 8) so that the beneficiaries receive a fixed percent of the trust principal if it is greater than trust income. The trustee may be given hold-back powers that would 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 and become a productive member of society.

## **USE OF TRUSTS 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 is usually 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 of property covered by the unified credit if the unified credit is also utilized. The unified credit portion can also be outright or in trust. Thus, if professional management of the tree farm will be in the surviving spouse's best interest, trusts can be used for the marital deduction bequest, the unified 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 unified credit trust (sometimes called nonmarital 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 figure 10.1 and

example 10.2). It can include sprinkle provisions as discussed above. The trust can provide that the income provisions terminate 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 that the surviving spouse not benefit from it for whatever reason.

In addition, several types of marital deduction trusts may be utilized (see chapter 6 for discussion of the marital deduction). These include power of appointment trusts, qualified terminal interest property (QTIP) 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 a life income interest. The key feature is the ability of the estate owner to control the disposition of the remainder interest after the spouse's death while at the same time utilizing the marital deduction for the trust assets in his estate. For example, when there are children from previous marriages, the grantor can be assured that their wants will be met at the surviving spouse's death. The surviving spouse must be given the trust income payable, at least annually, for life. The QTIP election must be made by the executor; a full or partial election can be made based on the form of the bequest and the degree of utilization of the full unified credit. For a more extensive discussion of QTIP's, 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 the 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 granted, 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, they 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 survivor's estate at that time. Thus, the survivor's will controls the disposition of the trust assets. This type of trust can also eliminate income distributions on remarriage of the surviving spouse and accumulate them for the eventual benefit of the surviving spouse's heirs. It can also hold nonincome-producing property with growth potential, such as timberland, which could pose a problem with a power of appointment trust.

### A Disclaimer

A qualified disclaimer by a surviving spouse (as discussed in chapter 7) 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 legacies that will permit the surviving spouse to receive a larger marital deduction amount. (See chapter 7 for more on disclaimers.)

## TRUSTEES

The selection of and powers given to the trustee(s) are a critical problem that bedevil many otherwise sound trust plans. The person or institution chosen as trustee must, of course, measure up in a practical sense. If timberland is an important part of the estate assets, a forester with business experience may be preferred, if not as sole trustee, perhaps as a cotrustee. Ability, integrity, judgment and durability are all important qualities for a trustee. State law requirements must be satisfied. These are particularly important 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. However, that may not be fair to the trustee because it takes valuable time to do the job right. The family member named may resent the imposition of the duties involved and/or make them a low priority in his (her) work schedule if uncompensated. On the other hand, an institutional trustee offers experience, continuity, and a variety of skills (usually in a department with several individual specialists). It may not, however, have the personal interest in the timberland 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 investments and income distributions. There may be additional fees for handling timber sales, preparation of fiduciary income tax returns, and other services that may be required. 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 tree farm to do the job that the grantor requires. There is always 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 timber properties, but others may want to dispose of the woodland and invest in more liquid investments.

### Family Cotrustees

In some cases a family member may serve as cotrustee with an institutional trustee. He (she) brings a common touch to the personal needs of the beneficiaries and a personal, sometimes sentimental, family attachment to the timber property. However, this will cost more, even if the cotrustee serves without fee, because additional time will be required for meetings, consultations, and resolution of conflicts. The cotrustee may also deserve a fee, which would be an additional expense. Thus, there are benefits and costs for both personal service and financial skills, which should be carefully considered and balanced.

Appropriate language should be included in the trust instrument to insure that favorable tax treatment will not be compromised by having beneficiaries as cotrustees.

### Successor Trustees

Naming of alternate trustees should be considered. Family members age and change, and institutions also change and may go out of business. Thus, the original trustee may not or cannot continue to serve at some point in time. Alternates should be named, or procedures should be in place, to address this contingency. Such foresight 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); 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 enable him (her) to accomplish the objectives of the grantor. 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 (timber capital and/or growing stock) and income (growth). Because timberland may be nonincome producing 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 is often prudent to include other income-producing assets in the trust in addition to timber in order to cover expenses in nonincome years or to permit retention of timber sale income for that purpose. The trustee needs sufficient flexibility to respond to changing economic and environmental conditions, market opportunities, and beneficiary needs.

## TRUST APPLICATIONS FOR FORESTRY

Timber is a unique asset. In most States, the title to standing timber can be legally separated from the title to the land on which it grows. In such a case, the timber continues to grow after severance of the title. Because the timber represents both the principal

and income and the land remains dedicated to the production of the timber, the severance of title necessarily reduces the value of the land because of the **incumbrance**. Therefore, the value of the land can be reduced for estate purposes without affecting its ability to produce a timber crop and thus income. This severance is not without cost, however, and may result in higher administration and management costs.

### Example 10.3. The Irrevocable Living Trust--A Case Study.

This is an actual case study that illustrates how a well-planned, well-managed, irrevocable trust involving timberland has worked over a 3-year period for a 20-year Washington Farm Forestry Association small timber landowner.<sup>1</sup> The following factors, all discussed in more detail elsewhere in this book, were considered by the grantor in establishing this trust.

Once the trust instrument--the guiding document that controls the trust, its assets, and the functions of the trustees for the duration of the trust--is completed, funding of the trust actually starts the business and management of the trust. This funding is achieved with property (timberland) and/or securities (stocks, bonds, or money accounts) and should involve good financial planning and knowledge of the way income will be produced, the income tax provisions, the cost basis of assets gifted to beneficiaries through the trust vehicle, and the impact of capital gains taxation, if the trust should sell timber or securities. Certain basic facts regarding gifts and taxation that are important are listed below.

- (1) Gift taxes are exempt on the first \$10,000 gift per donee per year or on the first \$20,000 from a married couple to each donee. If property is separately owned by one person with the \$10,000 exemption, the exemption can be increased to \$20,000 if the spouse consents, even though the spouse does not own the property. If the person or married couple decide they wish to exceed the \$10,000 or \$20,000 annual exemption, then a gift tax report must be filed, but no taxes need to be paid because the excess gifts can carry over to proportionately use up the unified credit for estate taxes--a \$600,000 estate tax exemption.

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<sup>1</sup>Used with permission of the author, who, although wishing to remain anonymous, welcomes any criticisms, comments, or inquiries by writing to Lori I. Rasor, Editor, "Northwest Woodlands," 4033 S.W. Canyon Road, Portland, OR 97221.

(2) If the gift donor's estate assets are above the Federal estate tax level (\$600,000 for one person or \$1,200,000 for a married couple), astute estate planning will involve gifting assets into the trust that have the potential of growing rapidly or that have longer term growth such as land (a scarce commodity), timber, which is also becoming scarce and is experiencing escalating market prices, and certain securities, namely common stocks in good investment grade companies over the long term. Stocks have outperformed most other investments, according to past history performance. Mature timber on good site land can grow 7 percent a year in board feet volume, compounded; therefore, timber value can double in 10 years in board feet volume.

(3) The capital gain or loss basis for income taxes for the trust assets is the cost basis of the assets gifted of the donor, which is carried over permanently to the donee. So, if assets such as timber are sold in the future, capital gains tax will be paid on the difference between the donor's original cost and the donee's sale value. The market value of the gifted asset, at the time of gifting, is used for the asset value at the time the gift is made, applicable where considering gift tax exemption calculations.

(4) Consideration should be made by the gift donor as to the annual income produced by the asset and the annual needs of the trust to cover expenses. The needs of the trust beneficiaries for annual income distributions for personal family support also should be considered.

In gifting securities, one would need to gift high-dividend or high-interest-producing securities to produce cash flow for the trust. These might be high-dividend stocks such as utility, petroleum, or natural resource stocks. The latter two pay good dividends and have a good growth record. Bonds have no growth factor other than high income (8 to 10 percent), which if reinvested, like compound interest, acts as an asset growth factor.

The following actual case history of a 3-year duration, family-oriented, irrevocable living trust, illustrates the above factors in funding a trust through gifts and eliminating future estate taxation problems.

The trust is named "XYZ Family Farm Trust." Its purpose is to hold, control, manage, and distribute assets and income from the trust to the children and grandchildren of the trust grantors, and to create a vehicle for future gifts of farm and timberland and nonreal estate assets for the future benefit of the beneficiaries.

The goal and wishes of the donors, in funding this trust, is that management through its trustees will preserve the assets of the trust, help those assets grow in value and not distribute the capital assets to beneficiaries without specific needs, such as worthy economic or business needs or support; housing, educational, or health needs; or necessary retirement income.

The trust was funded in the following manner:

#### 12-31-86--Initial funding

Real estate (timberland) deed recorded for first undivided one-third of 80 acres fully stocked with timber		\$70,000
Stocks-720 shares of Borg Warner @ 38 1/8		<u>27,145</u>
Total 1986		<u>\$97,145</u>

#### 1987--Funding trust

2-4-87--Real estate (timberland) deed recorded for a second undivided one-third of above 80 acres		\$70,000
3-4-87--Cash gift to establish a checking/savings account		<u>1,000</u>
Total 1987		<u>\$71,000</u>

#### 1988--Funding trust

3-3-88--Real estate (timberland) deed recorded deed recorded for a third undivided one-third of above 80 acres		\$70,000
12-24-88--Stocks (valued at closing of market Dec. 22)		
500 shares of Pacificorp @ 35 7/8		\$17,937.50
300 shares of Wash Water PWR @ 27 1/2		8,250.00
300 shares of Walgreen @ 30 5/8		9,187.50
400 shares of Enron @ 35 112		14,600.00
Total 1988		<u>49,975</u>
		<u>\$119,975</u>

## 1989--Funding trust

12-21-89--Real estate (timberland)  
deed recorded for 22.4 acres,  
fully stocked with timber

\$132,670

Total funding of trust, 3 years  
through 12/31/89

\$420,790

The summary of annual income, income  
distributions, and taxation are as follows:

### 1987--Income

Dividends on stocks	\$ 356.00
Interest on bonds	333.33
Interest on bank accounts	<u>1,146.00</u>
	<u>1,835.33</u>
Long-term capital gains	<u>31,145.58</u>
	<u>32,980.91</u>
Less expenses	6.50
Net taxable income	<u>\$32,974.41</u>

### 1988--Income

Note: Borg Warner stock merger 4/22/87 resulted in a  
\$31,145.58 capital gain. Income distribution: 30 percent  
retained in trust and taxed at an 11-percent starting rate.  
Seventy percent was distributed to beneficiaries and taxed  
mainly at 28 percent

Interest on bank accounts	\$ 115.73
Interest on corporate bonds	1,500.00
Interest on tax-free bonds	<u>654.44</u>
	<u>2,270.17</u>
Less expenses	<u>165.42</u>
Net income	<u>2,104.75</u>
Less tax-free interest	<u>654.44</u>
Net taxable income	<u>\$1,450.31</u>

### 1989--Income

Dividends on stocks	\$3,376.65
Interest on bank accounts	170.14
Interest on corporate bonds	1,500.00
Interest on tax-free bonds	<u>950.00</u>
	<u>5,996.79</u>
Less expenses	<u>141.60</u>
Net income	<u>5,855.19</u>
Less tax-free interest	<u>950.00</u>
Net taxable income	<u>\$4,905.19</u>

The year-end annual inventory of assets on  
December 31 of each year is as follows:

1986

Real estate, parcel 1, 80 acres  
(first one-third value)

\$ 70,000.00

Stock

27,145.00

Total 1986

\$ 97,145.00

1987

Real estate, parcel 1 (two  
one-thirds value)  
Bank accounts  
Bonds  
Total 1987

\$140,000.00  
3,279.74  
25,374.73  
\$168,654.47

1988

Real estate parcel 2 (three  
one-thirds value)  
Bank accounts  
Bonds  
Stocks  
Total 1988

\$210,000.00  
3,375.90  
25,374.73  
49,475.00  
\$288,654.47

1989

Real estate, parcel 1 (three  
one-thirds value)  
Real estate, parcel 2 (22.4  
acres of timberland)  
Bank accounts  
Bonds  
Stocks  
Total 1989 (on 12/20/89)

\$210,000.00  
132,670.00  
51,073.93  
25,374.73  
71,764.58  
\$444,883.24

This case history of an irrevocable living trust for a  
3 year duration illustrates an example of the original  
purpose and goal of the trust as mentioned above:

- (1) Gifts of timberland and/or securities into the  
trust (\$97,145 initially, cumulative current  
value \$420,790) removes these assets from the  
donor's estate and future estate and inheritance  
taxation.
- (2) The goals and wishes of the funding donors of  
the trust have been dramatically fulfilled--assets  
have grown in value. The current inventory of  
timberland is valued at the time of gifting into  
the trust and does not indicate current market  
prices for timber in parcel 1 nor does it  
include the annual compounded 7-percent  
growth in board feet volume. Present values  
are markedly higher today.
- (3) Securities, mainly stocks, had remarkable  
growth in value in 1 year--\$49,975 at the end  
of 1988 versus \$71,764.58 at the end of 1989--  
for an increased value of 43.6 percent,  
surpassing the growth in 1989 of the Dow  
Jones Industrial Average increase of roughly 20  
percent. Note: The 43.6-percent increase  
includes income reinvested in the Dividend  
Reinvestment Program.
- (4) The trust vehicle, under supervision of an  
experienced trustee, provides continuity of  
control of assets and, hopefully, good



management by one entity for the benefit, in this case history, of seven beneficiaries, of whom four are minors, and prevents injudicious expenditures of capital assets by a spendthrift beneficiary.

The timberland and securities were gifted into the trust over 13 months (3 tax years) in order to utilize the annual gift tax exclusions for the seven beneficiaries. Only one timberland appraisal was necessary because the assets were transferred into the trust over a span of 13 calendar months, which, by using the

end of 1 tax year and the beginning of 2 others, actually covered 3 tax years.

The rate of value appreciation for the timber, including both growth and price appreciation to mid-1992, was a robust 25.6 percent. Since then the **stumpage** prices for Douglas-fir, which comprises most of the standing timber, have more than doubled.

The grantor is the trustee, but he faces perhaps the most challenging aspect of the trust strategy in identifying a successor trustee who has the business acumen to manage securities and timber plus the personal interest in the welfare of the family.



# Chapter 11

## Life Insurance

### ROLE OF LIFE INSURANCE

#### Insurance Program

The life insurance program must be part of the overall evaluation of the estate plan. The estate planner should review all of the landowner's policies, inventory the provisions and benefits, and make projections of needed insurance changes over time in conjunction with other estate assets.

There are two primary reasons for buying life insurance: (1) to replace the foregone income of the principal breadwinner and (2) to provide liquidity. The liquidity is needed to prevent shrinkage from forced liquidations of estate assets under unfavorable terms, to cover the cost of estate administration, and to pay estate taxes, if any.

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 their last child. Insurance can provide an instant estate for the surviving spouse in the event of a primary breadwinner's premature death. Over time, the family's insurance needs generally decline with the self-sufficiency of the children and with the accumulation of capital assets, such as timberland and other retirement benefits.

There are also alternatives to insurance for liquidity purposes, such as government and corporate bonds, and publicly traded securities. These investments fluctuate in value, and there is always the risk that one or all could be at a low ebb in their cycle when cash is needed. However, the risk-return tradeoff is the nature of the investment choice. Most life insurance carries an investment component, which is relatively safe with highly rated companies. Insurance firms are highly regulated, well diversified, and professionally managed. A minimum return is usually guaranteed, but a policyholder should be cautious in believing the projected returns because they are just that--projections--and, thus, subject to error.

Life insurance receives favorable tax treatment under the Federal estate tax laws. Insurance payable to the named beneficiary is tax exempt in many States. The Federal estate tax exempts insurance

proceeds payable to beneficiaries other than the executor of the insured's estate, if the decedent retained no incidents of ownership in the policy at death. Insurance is also favorably treated for income tax purposes at the Federal level and in most States. In addition to favorable tax treatment, insurance benefits include the flexibility of different settlement options, financial security for survivors, and the convenience of low-interest, cash value loans when the policyholder may need them.

**Life Insurance Contract.**--Perhaps, the most important provision of the policy is that of ownership. The insured is usually the owner, but he (she) may divest himself (herself) of incidents of ownership and make the proceeds payable to someone other than to the insured's estate. With no incidents of ownership and with proceeds payable to a named beneficiary other than the estate, the value will not be included in the decedent's estate. Because the policyholder exercises control over the insurance contract, he (she) can name one or more beneficiaries including contingent beneficiaries. The owner controls the payment options depending on the needs of the beneficiaries, but the procedural rules of the policy should be followed carefully.

The insurance contract lists the schedule of cash value over time, if any. 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 is generally not the preferred method. 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 when the insured contracts a terminal illness. In effect, the insured draws on the

death benefit during his (her) life to cover living expenses associated with the final 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 rate that is available to the policyholder and is normally below the rate charged by commercial lenders. There are also various options for loan repayment, as well as provisions for premium payment with loan proceeds.

**Definition of Life Insurance.**--Life insurance is defined for tax purposes--estate, gift, and income--in Internal Revenue Code (IRC) Section 7702. The applicable test is basically the distinction between contracts of 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 for tax purposes. The cash surrender part is treated separately with the income being taxable to the insured. More importantly, all income--not only that from the current year but also that earned in prior years--will be included in gross income and taxed to the policyholder at ordinary rates. Income is defined in this context as the amount by which the net surrender value less the cost of insurance exceeds the premiums paid less dividends credited, if any. If a policy is disqualified, the pure insurance portion--the excess of the death benefits over the net surrender value--will qualify for the income tax exclusion. 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 policies are described below.

### Estate's Needs

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

### Uses

Insurance may provide equity for absentee heir(s) who have chosen to live and work away from the timberland. Insurance can provide liquidity to pay estate or other debts, protect a dependent's income stream, and perhaps accumulate funds for the parent'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 pure protection (term) and types of investment. Term insurance is the cheapest and provides the greatest protection per dollar invested in the short run. It may not be the best vehicle over time because the rates increase with the age of the insured and a person may become uninsurable. Term insurance is a means of deferring risk until the owner can afford higher cost, investment component policies. The ultimate choice of pure insurance versus insurance with an investment component depends on the opportunity for sound outside investments, the tax effects (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. Cash buildup in a policy reduces the actual death benefit, but at the same time, it increases the pool of funds against which the insured can borrow at a low, favored rate for any purpose.

### Term Insurance

Term insurance is purchased for pure protection. Policy premiums are related directly to probability of death. It is sold in fixed-benefit policies with increasing premiums or decreasing term policies with fixed premium payments. Some policies may be converted to whole life (see below) without a physical examination, which guards against the problem of insurability. The primary characteristic of term insurance is low-cost protection, and it is most suitable for an insured who needs large amounts of coverage for short periods of time--for example, a young, married couple who have young children. Reducing term policies are often a good idea in conjunction with mortgage redemption, installment contracts, or other short-term loan repayments.

### Whole Life Insurance

Whole life combines a cash value with pure protection. Payments in early years exceed the cost of pure protection. The saving-investment element of insurance found with whole life policies should be

compared with alternative saving opportunities. With ordinary life policies, the insured pays a fixed premium for life. Generally, the death benefits are fixed, there is a fixed maturity date, fixed premiums, and a fixed buildup of cash values. This is the most common type of policy, because it provides protection, some investment, and a source of emergency funds for young, single persons and newly married couples.

## Other Insurance

Numerous options are available for specialized needs, but all should be compared with alternatives. The Technical and Miscellaneous Revenue Act (TAMRA) of 1988 not only changed the definition of insurance, but it also instituted income tax changes for policies that fail a seven-payment premium test. The Act created a new category of policy called a modified endowment contract (MEC). An MEC satisfies the life insurance test but fails the premium test. That is, the cumulative amount paid on the policy exceeds the sum of the net level 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 (LIFO) 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 59 1/2. This penalty also applies to insurance policy terminations.

Single premium policies were hit hard by TAMRA because they were primarily designed 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 a high investment component have similarly been restricted by changes in the definition of life insurance under TAMRA (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 are most attractive to high-income individuals who want the tax-free buildup.

Spousal or second-to-die insurance is used to pay the estate tax liability of the surviving spouse. It is often used in conjunction with charitable remainder trusts (see example 8.7) to replace the principal that went into the charitable trust. First-to-die insurance is often used in buy-sell agreements to balance the interests of the heirs who choose to live in other areas with those who choose to live on the tree farm 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 payable to the estate or, if payable to others, from policies in which the decedent retained "incidents of ownership." Transfer of policy ownership within 3 years of the decedent's death, as discussed in chapter 8, will also result in a policy being included in the decedent's estate, together with any gift tax paid.

**Example 10.1.** The taxable estate of a landowner was exactly \$600,000 after careful estate planning. Unfortunately, the decedent forgot about an insurance policy of \$100,000 that he owned and which was payable to the estate to take care of beneficiaries' needs. The policy was includable in the decedent's estate, and the \$100,000 that the decedent had intended for the heirs' benefit actually amounted to \$63,000. This difference accounts for Federal estate tax only, and additional State death tax may be due. To avoid this problem all "incidents of ownership" must be transferred out of the insured's control more than 3 years before the date of death. The recipient must not be under any obligation to the estate for the proceeds or they will be drawn back into the estate. The term "incidents of ownership" is emphasized because it is defined to include the power to change the beneficiaries, cancel the policy, assign it, pledge the policy for a loan, or borrow against the cash value. The insured should not pay the premiums on the policy within 3 years of death 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.

## Transfers of Ownership

A transfer of insurance policy ownership results in a gift roughly equal to the cash value of the policy. The value of the gift of insurance is the cost of replacing the policy--the cash surrender value. The insurance company will supply the amount on request. This amount is generally much smaller than the face amount of the policy when it endows (that is, becomes paid up).

Premiums paid by the insured on his (her) life for a policy owned by the beneficiaries constitutes a taxable gift even though the donee's rights are conditioned on their surviving the insured. The \$10,000 annual gift tax exclusion is available for the transfer of the insurance policy and for making gifts of the premium payments. If the payment is for premiums of insurance held by a trust, the gift is treated as a future interest and the annual exclusion is not available. The unified credit can be used to cover the gift and premium payments. If the donor makes a split gift of insurance or premiums within 3 years of death, there is an exception that expressly exempts the transfer of life insurance [IRC Section 2035(b)(2)].

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

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 beneficiary nor should a policy be subject to a loan. Both situations cause problems.

### CHOICE OF BENEFICIARIES (INCLUDING CONTINGENCIES)

#### Tax Liability

Beneficiary designation is especially important in determining if 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 set up by the insured, or one or more individuals?

If proceeds are made payable to the executor of the estate, they are includable in probate and increase administration cost, and estate tax, if taxable. 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

Beneficiary designation is extremely important in determining the overall plan for the distribution of assets. It should be coordinated with the will, any trusts established, and the overall plan.

A responsible individual (family member), who can be trusted to make the proceeds available to meet the estate's liquidity needs, will keep the proceeds out of probate. If the owner does not have an individual in whom he (she) has confidence, a trust should be considered.

Normally, the spouse is named the beneficiary with the children listed as contingent beneficiaries. Doing so will avoid probate and, generally, State death taxes. However, if the children are minors, a guardian will have to be appointed for each with added expense and complications.

#### 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; 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 is also the ability to put restrictions and limitations on 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 most important and must be balanced against the costs, broadly defined, of using a trust.

**An Irrevocable Insurance Trust--** The advantages to be gained are avoidance of estate taxes, avoidance of probate, and possibly avoiding State death tax. 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 10--loss of control and the gift tax liability in establishing the trust. These are complex problems and should be considered with the expert advice of 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--amount is fixed for a specific period after which the balance is payable under some other option, and (4) life income--an annuity for life. The choice is basically a gamble and, once made, involves rigidity not present in a trust. An insurance specialist should be consulted in arriving at the best choice for meeting the individual's objectives.

### **Replacing Policies in Force**

Replacing policies in force is rarely advisable due to new acquisition costs, policy value increases with age, a contestable period, unequal dividends, unequal cash values, and replacement by policies of a different type.

## **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. Avoid rules of thumb such as the 10-times-earnings rule.

### **Income Producer**

The insurance should be concentrated on the person who generates the family income. This is the income

stream that requires replacement if the generator dies prematurely. First, information about the family assets and liabilities and the family estate plan should be assembled. What are the family's 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 because anything more than 10 years is pure guesswork. The effects of an untimely death of the primary breadwinner should be calculated--such as estate taxes, administration costs, funeral expenses, and family income needs due to the loss of his (her) salary and leadership. The status of the liquid funds needed to maintain the family's standard of living should be evaluated. That is, will the family have to cash in principal in the form of savings accounts or harvest timber to meet the deficits? What are the family's goals for shelter, college, retirement, recreation, more timberland, or better management of what is owned?

If the primary income producer should happen to die before the family goals are met through hard work, how much and what kind of insurance is needed to protect the family? There are two basic courses of action if the resources are not sufficient to meet the goals--increase earnings or reduce costs and goals. Insurance can fill some of the gaps.

### **Periodic Review**

The policies should be reviewed periodically so that adequate coverage will continue to be provided at affordable cost. Also, the steps that are outlined above should be reviewed periodically. What are the resources? What are the goals? Can the resources (timberland, growing stock, and capital) be increased to produce the income (growth) that is needed to meet the family's goals?

### **Minimum Standard**

Use insurance to bring income protection up to the minimum level desired to assure a particular standard of living.





# Chapter 12

## 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. An outright sale, on the other hand, triggers immediate recognition of all gain in the year of sale for income tax purposes. Although the 1987 Revenue Act repealed the installment sale method of reporting for dealers in real and personal property, it specifically exempted sales of property used or produced in the trade or business of farming as defined in Sections 2032A(4) and (5) of the Internal Revenue Code (IRC) (see chapter 13). This definition of farming includes timber growing.

In addition to the income tax advantages, installment sales can also be a good estate planning tool. 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 former requirements that an installment obligation must have two or more payments spread out over at least 2 tax years and that the payment(s) in *the* year of sale not exceed 30 percent of the selling price were repealed in 1980. Now the installment method of reporting gain is available when at least one payment is to 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 tax 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 is usually the year of transfer of possession, or the year of title passage, whichever occurs first.

**Example 12.1.** Suppose a forest landowner agrees to sell his tree farm for \$150,000 and receives a down payment of \$2,000 on September 15, 1992.

The first installment payment of \$25,000 is received on April 30, 1993, and possession is given to the buyer at that time. A total payment of \$27,000 is reportable as income by the seller in 1993.

### 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 Section 1239(b) of the IRC, 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 governs the sale of nondepreciable property between related parties and then a resale by the purchaser. If the purchaser, in turn, sells the property before the installment payments are made in full, the amount realized by the related party second seller from the second disposition is treated as being received by the initial seller at that time. In other words, the first seller's gain is accelerated to the extent of the payment received by the second seller. In many 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, and sister; and corporations, partnerships, and estates that are 80 percent or more owned 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 of such a reporting method. This "negative" election recognizes that almost all taxpayers prefer the installment method of reporting income when possible. An election not to use the installment method 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.

## Computing the Gain

In order to compute the portion of each installment payment that will be reported as gain, the selling price (the contract price) and the gross profit must be determined. The selling price includes the amount of the down payment, the face value of the installment obligations, and the amount of any liability or indebtedness that the purchaser assumes. Gross profit is the difference between the selling price and the seller's basis in the property. The contract price is the selling price less the amount of liabilities or indebtedness assumed by the purchaser. However, if the liabilities or indebtedness exceeds the seller's basis, the excess is not subtracted from the selling price to calculate the contract price. Once the gross profit and contract price have been calculated, the percentage of each payment to be reported as gain is determined by dividing the gross profit by the contract price. The following example illustrates the computation procedures:

**Example 12.2.** The taxpayer decides to sell 150 acres of timberland on the installment method and enters into an agreement providing for a \$20,000 down payment, annual installments of \$7,000 each over a period of 10 years, a final balloon payment of \$25,000, 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	70,000
Balloon payment	25,000
Assumption of mortgage	<u>65,000</u>
Selling price	\$180,000

Gross profit	
Selling price	\$180,000
Adjusted basis	<u>- 50,000</u>
Gross profit	130,000
Sale expenses	<u>- 5,000</u>
Gross profit to be realized	\$125,000

Contract price	
Selling price	\$180,000
Mortgage assumed	<u>- 65,000</u>
Subtotal	115,000
Mortgage exceeds basis	<u>+ 15,000</u>
Total (contract price)	\$130,000

The percentage gain on each payment is:

$$\$125,000/\$130,000=96.2\%.$$

## ESTATE PLANNING CONSIDERATIONS

### Advantages

An installment sale contract may be an ideal tool for parents to use if they wish to begin lifetime transfers of forest land to their children. Such contracts may be particularly attractive to a surviving spouse wanting to avoid heavy involvement in management of the tree farm. In this regard, the following can be accomplished: (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 income not subject to the social security tax or reducing social security benefits, (3) management responsibility can be transferred to the children, (4) an opportunity for the children to acquire an interest in the property with a low down payment can be provided, (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 may also 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. Inflation may elevate the parents' cost of living to a point where they will 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

It is necessary to give careful consideration to establishing the price and terms in an installment sale in order to further the objectives of transferring future appreciation out of the parent's estates, and facilitating 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 the price is too low, the transaction may be characterized as part sale and part gift, thus making the sale subject to gift tax as well as income tax.

If the parents are concerned that the child (children) purchasing the tree farm will have difficulty in generating a 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. Because transfers of property between family members will be carefully scrutinized to determine whether a gift has occurred, unless a gift is intended the parties must structure the sale to insure that it has the characteristics of a 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 is always 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, it might be advisable, if the sale is substantially below market, to file a gift tax return at the time of transfer.

### **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 the parents to convey the woodland to a child or children and avoid the gift tax by keeping annual gifts to each child within the \$20,000 split gift tax exclusion amount. For example, if the parents have already used their unified credit against gift taxes and wish to give the tree farm to their children, the value of the gift in excess of \$20,000 per child would be subject to gift tax. If the parents wished to stay within the \$20,000 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 woodland to the children while making it possible for the parents to stay within the exclusion amount for each child.

For example, the property may be conveyed in exchange for \$10,000 principal amount, interest-bearing notes, payable semiannually. If the parents wish to make a gift to the acquiring child, they may forgive 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*, 63 TC 321 (1974); and *Hudspeth v. Commissioner*, 509 F2d 1224 (9th Circuit 1975)].

## **INSTALLMENT OBLIGATION DISPOSITIONS AT DEATH**

### **Income Tax Basis**

Generally, upon 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 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 immediately recognized 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 canceled by the seller’s executor. For example, suppose a father sold 10 acres of woodland to his only son, John, in 1990 for \$96,000 using an installment sale. After receiving the first two payments under the contract, 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 but 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 has to be 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 causes immediate taxation of the gain in the obligation under all circumstances. For some assets with a new income tax basis received at death, the amount of gain may be little or none. But if the sale involves timber property that had been valued under special use valuation (see chapter 13), the amount of gain could be substantial. The new basis at death would only be up to the value set for Federal estate tax purposes--in this case, special use value--and not up to fair market value.

### **PART III**

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



# Chapter 13

## Special Use Valuation

Section 2032(A) 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 at “highest and best use.” This is commonly 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. 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 woodland. The term “farming purposes” includes the planting, cultivating, caring for, cutting down, and preparing for market of trees. The 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. If the woodland in question was owned by both spouses, the \$750,000 limitation applies to each estate. Consequently, a reduction in value of up to \$1.5 million is available. 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 (\$750,000) is allowed for a decedent’s community property interest in timberland, even though the decedent made no contribution to the property (Letter Ruling 8229009). Revenue Ruling 83-96 applies the same rule to all community property eligible for special use valuation.

### QUALIFYING CONDITIONS

In the right situations, special use valuation of tree farms can save substantial amounts of estate taxes.

Careful planning--both predeath and postdeath--will be required, however, in order to qualify and receive the maximum benefits. There are six major predeath requirements, as follows:

- (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 member of his (her) family must have owned the qualifying property for at least 5 of the last 8 years immediately preceding the decedent’s death; and during at least 5 years of such ownership, the qualifying property must have been used for farming or a closely held business purpose--to include timber growing--by the decedent and/or a member of the decedent’s 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.
- (6) At least 25 percent of the adjusted value of the decedent’s gross estate must be qualified real property.

Requirements 2 through 6 will be discussed in more detail in the following paragraphs.

### Qualified Heirs

The term “qualified heir” is defined as an ancestor of the decedent; spouse of the decedent; lineal descendant of the decedent, of the decedent’s spouse, or of 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 must also meet the definition of "qualified heir." 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 (*I.M. Cone Estate*, 60 TCM 137, TC Memo 1990-359).

**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. 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 (Letter Rulings 8244001, 8441006). Also, the Internal Revenue Service (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 for a discussion of disclaimers) of the power of appointment, thus causing the remainder interest to vest in another qualified heir (Revenue Ruling 82-140). Additionally, at least three court decisions have held that, when unqualified heirs are in a position to receive remainder interests, special use valuation will not be precluded if the possibility of receiving those interests is extremely remote (see *D. Davis IV Estate*, 86 TC 1156; *C. M. Clinard Estate*, 86 TC 1180; and *L. Smoot, Executor*, CA-7, 90-1 USTC 160,002).

**QTIP Trusts.** --Proposed QTIP regulations (see chapter 6 for definition and discussion of QTIP) may have created a trap for the unwary in the use of a QTIP trust to receive property for which a special use valuation election is planned to be made in the surviving spouse's estate. Under Proposed 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-years requirement for predeath qualified use will be met if either the decedent or a member of his (her) family has utilized the property for the required time in a qualified use. "Member of family" is defined to include the same persons as are listed in the definition of "qualified heir." The IRS has further interpreted the qualified use requirement to mean that the decedent or a family member must have borne some of the financial risk (have had an equity interest) associated with the operation (Technical Advice Memorandum 8201016, 9-22-81). 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 has also mandated that qualified use be synonymous with a profit-making activity by the decedent (Letter Ruling 8820002). Here the estate included forest land and a cattle operation. 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 Letter Ruling 9117046, 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. The heirs 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 2032(A) discuss in detail the factors to be considered in determining whether the decedent and/or a member of his (her) family 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 is also an indicator of material participation. Although payment of such taxes is not conclusive evidence, if they 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 tree farms unless timber sale receipts are reported as ordinary income.

**Other Considerations.**--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).

**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 was actually 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 IRS Section 2032A material participation regulations concerns a tree farm. Although not definitive of each timberland situation, the example does provide an insight as to how the IRS views material participation with respect to woodland.

**Example 13.1.** [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 forestry example above has been considered in at least one court decision (**Sherrod v. Commissioner, 82 TC 40**). At death, the decedent (Mr. 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 it 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 trespassers, insect infestation, and disease; (4) negotiation of timber-cutting contracts; and (5) payment of property taxes. Timber harvesting consisted of selection cutting and 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 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 woodland are not necessarily those required for good management of another timber property.

**The Mangels Case.**--Timberland material participation has also been considered in at least one other court decision (*Mangels*, DC Iowa, 4/22/86). Here, for 6 years before the decedent's death, her conservator, a bank, leased her timberland and pasture on a cash basis to parties unrelated to her. The issue was whether the material participation test was met. The court ruled for the government. 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.

**Gift 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 13.2.** Mr. Tree Farmer, a widower, owns a tree farm with a fair market value of \$300,000 and a special use value of \$150,000. His other assets, which are not eligible for special use valuation, have a fair market value of \$400,000. The total estate thus has a fair market value of \$700,000. On this basis, the tree farm could not qualify for special use valuation because its fair market value is only 42.9 percent ( $\$300,000 \div \$700,000$ ) of the fair market value of the total estate. Assuming no change in asset value, \$100,000 would be subject to Federal estate tax at Mr. Tree Farmer's death. With the special use valuation percentage requirements in mind, Mr. Tree Farmer gifts \$105,000 of securities to his only child, using \$95,000 of his unified credit. The fair market value of the estate is now \$595,000, with the tree farm's fair market value now comprising more than half. Mr. Tree Farmer gives a sigh of relief--he has just saved \$33,300 in estate taxes--or so he believes. Unfortunately, he has a heart attack and dies 35 months after making the gift. The gift will, therefore, be brought temporarily back into his estate for the sole 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 once again drops below 50 percent.

Eligibility for special use valuation has been lost, and the estate is liable for more than \$33,000 in unanticipated Federal taxes. If Mr. Tree Farmer had died 3 weeks later, special use valuation could have been elected with the result that no estate taxes would be due.

## 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 Form 706 (U. S. Estate and Generation Skipping Tax Return--see appendix) by checking the box marked "yes" in the "Elections by the Executor" section of the return. For timber properties, a second election is also necessary by checking the woodlands election box in part 2 of schedule A-1. The elections may be made on a late-filed return if it is the first return filed. 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. However, as noted earlier, real property for which an election is made must comprise at least 25 percent of the total value of the adjusted gross estate.

**Corporate and Partnership Interests.** --In order for a decedent's partnership interest in qualified property to be eligible for the special use valuation election, 1 of 2 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 page 98 for a discussion of partnership capital interest) must be in the decedent's estate. Eligibility requirements for corporate interests are similar. The corporation must have had 15 or fewer shareholders, or 20 percent or more of the voting stock must be included in the decedent's estate.

**Protective Election.** --**When** it is not certain that real property meets the requirements for special use valuation, the estate executor may make a protective election to specially value the 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.

**Technically Defective Elections.** --If a timely special use valuation election **is** made, and the estate tax return, as filed, shows evidence of substantial compliance with the requirements relating to special use valuation, the executor has a reasonable time--not to exceed 90 days--in which to cure any technical defects or flaws in the form of the election that would prevent it from being otherwise valid. The 90-day period commences following notification by the IRS that a defect exists. Examples of such technical defects or flaws are the failure to include all required information in the notice of election and the failure to include signatures of heirs with relatively small interests.

### The Agreement

The "Agreement to Special Use Valuation," which is part 3 of schedule A-1 of the Federal estate tax return, 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 are 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 postdeath requirements (as discussed on page 87) 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 is not enough (Technical Advice Memorandum 8602007, 9/7/85). 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 the recapture tax. The trustee's signature alone is

insufficient (Technical Advice Memorandum 8802005, 9/29/87).

**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 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.

## 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 woodlands, either bare land or standing timber or both may be specially valued. Often, it is only by including some or all of the standing timber on the property that the 50- and/or 25-percent tests can be met. For a detailed discussion of the procedures applicable to fair market valuation of timber property, see chapter 4.

### Alternate Valuation

When an estate elects to use the alternate valuation date of 6 months after the decedent's death (see chapter 4 for a discussion of the alternate valuation date) and also elects special use valuation, the special use value must be determined as of the alternate valuation date. The alternate valuation date must also be used when determining whether the aggregate decrease in value of the qualified property exceeds the statutory limit of \$750,000 (Revenue Ruling 88-90).

### Special Use Valuation of Woodlands

Timberland special use valuation procedures must follow the general special use valuation rules applicable to farms, as set out in the IRS regulations. No valuation procedures specifically applicable to woodlands 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, minus 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 5 most recent calendar years ending before the date of the decedent's death.

Timberlands in the South are sometimes specially valued under the farm method by using rental payments specified in long-term leases of forest lands to forest product companies--when the details of such leases for comparable forest property can be obtained.

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 timberland 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 sales price; and (5) any other factor which fairly values the farm value of the property.

The IRS has ruled, with respect to the multiple factors method, that 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, depending on the circumstances, certain factors can be weighed more heavily than others (Revenue Ruling 89-30).

**Technical Advice Memorandum 9328004.** --The IRS recently (March 1993) addressed the valuation method to be used for special use valuation purposes with respect to 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 woodlands and that 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 woodlands and how it is to be used to specially value forest property.

**Woodland 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. Purely speculative and inflationary components of value are designed to be eliminated by the election. Factors 1, 3 and 4 above are the most likely to apply to forest land. Of these, income capitalization is probably the most often used factor. This method of valuation, depending on the circumstances and characteristics of the property involved, may actually result in a value lower than the current market value for timber use.

## POSTDEATH REQUIREMENTS

Certain requirements must continue to be met during a 10-year recapture period measured from the decedent's date of death. If not met, a recapture tax applies.

### Continued Ownership within the Period

Ownership of the specially valued property must continue solely within the decedent's family, as the term "family members" was defined earlier. Exceptions apply in the event of 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 an exchange must also be employed in the same qualified use.

### Material Participation

At least one member of the decedent's family as defined earlier must materially participate in operation of the property during 5 of every 8 years before the qualified heir's death during the 10-year period following the decedent's death. The less stringent active management test, as discussed on page 83, may be substituted for material participation by surviving spouses, 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 (Letter Ruling 8652005).

### Qualified Use

The property must continue to be used and managed for the qualified use. 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; 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 (Letter Ruling 8652005).

### 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 postdeath 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, when 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 (sale of the property).

### Conservation Reserve Program Enrollment

Letter Ruling 8745016 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 cropland 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.

### 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 that special use valuation has 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 arm's-length sale--exceed 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). However, if 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 (Letter Ruling 8902002).

### Recapture Lien

A government lien is imposed on all qualified property for which a special use election has been made and applies to the extent of any recapture tax that may be imposed. It 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) until 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 exchange 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's liability for the recapture tax can be extinguished in two instances: (1) if the recapture period lapses and (2) if the heir dies without converting or disposing of the property. 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 of further liability.

**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.

### 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 disposition 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, therefore, 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 woodland 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 was 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 (**Donald C. Peek**, TC Memo 1983-224, TCM 1382). Calculation of the recapture tax with respect to the sale of a tract of farm and forest property is set out in Letter Ruling 8741048.

**Designation of Specially Valued Timber.**--In most instances, executors will probably 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 utilized 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. If older timber is also to be specially valued, the most feasible way would be to do it on an acreage basis as well, for the same reason--describing specifically 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 definitely 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 he could 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 took the position, however, that the volume breakdown applied to each tree--not to the stand as a whole--and, therefore, part of each tree was specially valued and the other part of the tree was not. 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 potential 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 value per acre 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 in the family, while preserving other property for future liquidation, if desired.





## Chapter 14

### Deferral and Extension of Estate Tax Payments

#### OVERVIEW OF THE ESTATE TAX

The estate tax is due and payable at the same time the tax return is due, that is 9 months after the date of death. It must be paid within the time prescribed to avoid assessment of various 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 IRS. 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 the 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—including an interest in timberland—may, by meeting certain requirements, qualify for a special elective method of paying the estate tax attributable to that interest. Under IRC Section 6166, 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 coincides with the due date for the first installment of tax. Election of special use valuation as discussed in chapter 13 does not prevent an election under Section 6166.

#### Percentage Test

The closely held business interest must comprise more than 35 percent of the decedent’s adjusted gross estate. It can be composed entirely of timber property, or partially include timberland, but must be an active business. If special use valuation has been elected by the estate (see chapter 13), that value is used for purposes of determining whether the 35-percent test has been met.

*Mortgage Effects.*—Insofar as the eligibility of an ownership interest as a percentage of the decedent’s 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. See IRS Letter Ruling 8515010, which 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, low, 4-percent rate, compounded daily, on the portion attributable to the first \$1 million in value of the closely held business. After accounting for the unified credit, this means that a maximum of \$153,000 in tax is covered by the 4-percent rate--a significant advantage for a qualifying estate. Amounts of deferred tax beyond that level are subject to interest based on the Federal short-term rate, also compounded daily. Interest payments are deductible for income tax purposes or as an estate administration expense if also deductible for that purpose under State law.

### Making the Election

The 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 not certain at the time of filing the return that 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 must then be filed within 60 days after it has been determined that the estate qualifies for the election.

### Acceleration of Unpaid Taxes

Deferred tax payments are accelerated if more than one-half of the value of the qualified business interest is withdrawn or disposed of during the deferral period. 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.

**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 6 months of its original due date. The late payment, however, will not be eligible for the special 4-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 is basically 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. These exceptions are as follows: (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 the raising of livestock or other animals.

### What Constitutes a Closely Held Business Interest?

**Sole Proprietorships.**--**Sole** proprietorships may qualify as closely held businesses. 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.

**Partnerships.**--If certain rules are met, partnership interests may qualify. Either 20 percent or more of the partnership's total capital interest (see page 98 for a discussion of partnership capital interests) 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 15. The inclusion of the value of passive assets held by a partnership is disallowed for purposes of the 35-percent test. Partnership interests held by a decedent's family are treated as if owned by the decedent. Internal Revenue Code Section 267(c)(4) defines the family of an individual as including brothers and sisters (whole- or halfblood), spouses, ancestors, and lineal descendants. 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.

**Corporations.**--Corporate interests may also qualify as interests in closely held businesses. In order 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 15. 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 partnerships, corporate interests held by a decedent's family are treated as if owned by the decedent. The definition of family is as noted above. 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.

**Trusts.**--The installment payment IRC 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.

### When is a Closely Held Business an Active Business?

The line between what is and what is not an active business is often a fine one. The required involvement for installment payment purposes can be contrasted with the material participation requirements for special use valuation as discussed earlier. There are two key differences between material participation for purposes of special use valuation and the necessary activity for purposes of Section 6166. For purposes of Section 6166, the question of whether the operation amounts to an active business is determined as of immediately prior to the decedent's death. For special use valuation purposes, material participation by the decedent or a family member is required for 5 or more of the last 8 years before death, retirement, or disability, whichever occurs earliest. It cannot be gained through the services of an agent, such as a property manager. On the other hand, even an unrelated agent, as well as a family member, can assure the necessary degree of involvement for purposes of Section 6166 (IRS Letter Ruling 8020101). Section 6166 eligibility can also be established through power of attorney (Letter Ruling 8134010).

**Disqualification Not Appealable.**--An IRS determination that an estate does not qualify for a Section 6166 election because the decedent's activities did not constitute an interest in a closely held business is not appealable to the Tax Court. See *Estate of Sherrod* [82 TC 523, 85-2 USTC 13,644 (CA-II)] in which the decedent's activities with respect to his timberland were held by the IRS not to constitute an active trade or business for Section 6166 purposes. The court noted that its jurisdiction was strictly limited by statute and that it did not have the authority to enlarge upon the sole statutory grant of jurisdiction given to the IRS with respect to Section 6166 eligibility.

**Technical Advice Memorandum 8437001 (May 9, 1984).**--Here the IRS held that 5,126 acres of timberland owned by the decedent (comprising 87.7 percent of the adjusted gross estate) did not qualify as an interest in a closely held business within the meaning of Section 6166(b)(1)(A) of the IRC. The decedent's

activities with respect to the property included visiting the property routinely to observe timber growth and development, and to study the land and its potential for raising timber; making management decisions, such as whether to plant seedlings, when to sell timber, whether to clear and replant after cutting, and in general what forestry techniques were best suited to his particular situation; negotiating contracts for the sale and harvesting of timber; observing cutting operations to insure compliance with contract terms; and overseeing the maintenance of roads and firebreaks, and the prevention of trespass. During a 6-year cutting contract, however, the decedent had granted the contractor almost complete control over the cutting operation and the property. The IRS found that during this period the decedent's prerogatives with respect to the property were limited to policing the cutting for the purpose of enforcing the contract terms, and that the cutting arrangement was thus similar to a "net\ net" lease arrangement wherein the lessor merely receives a net income based on ownership of the leased property. This fact was the overriding factor in the IRS conclusion that the decedent's relationship to his timber assets was not that of a proprietor carrying on a trade or business.

**IRS Atlanta District Memorandum.--In an** unnumbered and undated memorandum issued by the IRS Atlanta District Office, the IRS held that the nature and level of the decedent's activities with respect to his nearly 500 acres of timber property was insufficient to constitute an active trade or business for Section 6166 purposes. The estate representative's statements that the decedent had actively managed the property in accordance with good forestry practices was countermanded by an IRS appraiser who stated that the timber was all natural; that none had been planted; that there was no evidence of cutting in recent years or of thinning; that the only firebreaks were roads; and that there had been no prescribed burning within the past 5 years. He concluded that the decedent had just let the timber take its natural course and that there was no evidence of forestry practices.

Letter **Ruling 9015003 (December 22, 1989).**--In supplementing Letter Ruling 9001062, 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; daily operations and timber sales were 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 Section 6166(a), activities of an agent may be attributed to a decedent. In this case, the trustee was the decedent's agent.

### **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 have all been held not to accelerate payment. Installment sale of property, however, 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 the Conservation Reserve Program is not a withdrawal or disposition (IRS Letter Ruling 9212001). 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 Letter Ruling 8722075, an estate's partition of an undivided interest in woodlands, followed by a like-kind exchange, did not affect the 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.

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 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, woodland owners 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. In order to reduce the adjusted gross estate,

the types of expenses which may be deducted to arrive at it should be reviewed for possible changes (see chapter 3 for a discussion of adjusted gross estate).

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

Special use valuation should also be carefully evaluated. While its election will decrease estate tax liability, its use may preclude qualifying for installment treatment. The value of deferring the estate tax payments should be compared to the value of the estate tax reduction.



**PART IV**

**FORM OF TIMBERLAND OWNERSHIP AND BUSINESS ORGANIZATION**





# Chapter 15

## Sole and Joint Ownership Considerations

### SOLE OWNERSHIP

Ownership of property in one name is normally the simplest method and gives the holder the most complete ownership possible. Transfers are relatively easy because the holder of title to the property has the absolute right to dispose of it under most circumstances. In some cases, a spouse may have to consent to the transfer of real property owned solely by the other spouse because of the dower right available under the laws of some States. 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.

### JOINT OWNERSHIP BETWEEN SPOUSES

A key estate planning element for family-owned timberland is the manner in which the property is held by husband and wife. Typically, the spouses have worked together to accumulate and manage the woodland. 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 or 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.

The distinguishing feature of tenancy by the entirety is that no partition or severance of the ownership of real property or destruction of the survivorship feature can be achieved by the unilateral action of either spouse. Many States have abolished this concept as a form of property holding; others have continued it, sometimes with modifications.

Where tenancy by the entirety has been abolished, common law joint tenancy may generally 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. A joint tenancy, in addition, may be created among nonspouses. Joint tenancy also permits partition of the property at the will of any of the cotenants, unlike tenancy by the entirety.

### 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 is generally that received by either spouse by inheritance or gift and that owned prior to the marriage. Generally, in community property States, the surviving spouse is protected to a greater degree in the succession to community property than in succession to separate property. The profits and earnings from community property, and in some cases from separate property, are considered community as well.

### Advantages of Joint Ownership

In many States, the probate procedure is perceived to be so cumbersome, time consuming, and expensive that joint tenancies are 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 has been commonly utilized as a substitute for more complex business organization arrangements.

Survivorship property ownership arrangements can **offer** each 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 Joint Ownership

**Basis Limitations.**--Despite the valuable uses of joint property holding arrangements between spouses, there are potential problems--particularly with respect to those estates that have values greater than the unified credit exemption equivalent. When spouses are exclusively joint tenants in property, regardless of which spouse provided the consideration for the jointly held 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, the surviving spouse in noncommunity property States will receive a stepped-up basis only in that property included in the gross estate of the decedent spouse. If the first spouse to die had owned all of the property, a full step-up would be obtained.

**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 post mortem estate planning tool is extremely limited. Only a few States permit a disclaimer of the interest in property that has been perfected in the survivor. Thus, this highly desirable method of post mortem tailoring of property descent is not available if not provided for by State statute, and the resultant **afterdeath** tax planning is generally denied to the surviving joint tenant.

Additionally, the Internal Revenue Service (IRS) has taken the position that a disclaimer of a joint tenancy interest is not effective for estate tax purposes, even though it may be valid under State law, on the ground that the donee accepted the property when the joint tenancy was created (Letter Rulings 7829008, 7911005, and 7912049). The reasoning set out in the rulings is that property transferred to a

joint tenant who may become the survivor is accepted by that joint tenant when the joint tenancy is created and, thus, must be disclaimed within the statutorily required period of 9 months from the date of creation of the joint tenancy. It is the position of the ruling that by the time of the death of the first tenant to die, acceptance has been completed, and the statutory period for the disclaimer has expired.

### Postdeath Income Tax Considerations

Another disadvantage of joint tenancy involves postdeath 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 deceased, there is no intervening estate to act as a taxable entity. Thus, the surviving joint tenant cannot take advantage of the post mortem tax options generally available to estates.

### Creation of Joint Tenancies in Real Estate

Most States with joint tenancy statutes now permit the creation of joint tenancies in real property by a conveyance to the joint tenants(s) that sets forth the existence of the survivorship feature. In those States that recognize tenancies by the entirety, State statutes and sometimes case law provide various methods of creation. Once such ownerships have been established, the ownership of 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. Profits and proceeds generally, including those from the sale of standing timber, that are derived from entirety property are themselves treated as entirety property. Similarly, property purchased with the proceeds from selling entirety property is also entirety property. Income realized from joint tenancy property, on the other hand, is treated in most States as the separate property of the joint tenants in proportion to their ownership interests.

### Federal Estate Tax Aspects of Joint Tenancies

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(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.

*Nonspousal Joint Interests.*--Section 2040(a) applies to all situations involving nonspousal joint interests. The value of any such joint interest held by the decedent at death is to be included in his (her) gross estate to the extent of the decedent’s fractional share of the property, in cases where the property was acquired by gift, bequest, devise, or inheritance; or

to the extent that it cannot be demonstrated that the surviving tenant(s) provided consideration for the acquisition of the property in those cases in which the property was acquired by other means. Thus, if a personal representative is unable to show that the property was acquired by gift, bequest, devise, or inheritance--or that the surviving tenant(s) provided consideration for acquisition of the property--the value of all of the jointly held property will be included in the decedent’s gross estate. Because determination of the amount of consideration provided by each tenant can sometimes be difficult, it is very important that accurate records be kept when using nonspousal joint property-holding arrangements.



# Chapter 16

## Partnerships

Most family timberlands have been traditionally operated as sole proprietorships or in joint fee ownership. Increasingly, however, nonindustrial woodland owners are turning to partnerships and corporations as ownership vehicles, particularly if two or more persons are involved in the ownership or management. This is due in part to the increasing financial values associated with managed woodlands and the desire to utilize prudent business and income tax practices. However, there is also a special interest in using partnerships and corporations for estate planning purposes.

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

### DEFINITION OF A PARTNERSHIP

A partnership is generally defined as an association of two or more persons, as coowners, to operate a business for profit. Tests for determining what is and what is not a partnership have been developed in each State. 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 generally 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 and to state clearly 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 later, 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 utilize 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 on the partnership books rather than percentage adjustments makes gifts and sales of partnership interests to family members easier to accomplish. Such transactions can be made by simply transferring certificates.

### PARTNERSHIP ATTRIBUTES

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

### Flexibility

As compared to corporations, partnerships are extremely flexible devices. The partnership agreement can easily be amended up until the time the partnership income tax return is filed in order to realize desired economic and tax consequences. This additional flexibility in structuring financial arrangements may lead, however, to a substantially more complex partnership agreement and increased scrutiny under the Federal income tax law.

Contributions.--Contributions of property may be made to a partnership without recognition of gain; in some cases, this is not possible with a corporation. The partnership adopts the partner's basis for property transferred to it, and the contributing partner's capital

account, in turn, 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 being 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. Corporate distributions, on the other hand, are treated as dividend payments or, if made as liquidating distributions, as payments in exchange for stock. And finally, liquidation of a partnership is generally a nontaxable event. This is generally not the case with a corporate liquidation.

### **Unlimited Liability**

Probably 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; they can then make a claim against the personal assets of the individual partners if any debt remains. 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 later.

### **Management Rights**

In a general partnership (as opposed to a limited 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 of the members. Both 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, partnership statutes permit almost complete flexibility subject to the requirement that the partners all agree.

### **Partners as Agents**

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

### **Partnership Termination**

A partnership may not have as much stability as the members might like. As with a sole proprietorship or joint ownership, a partnership is generally 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 do not generally force partnership continuation 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 are generally under a duty to wind up the business and make a distribution to the deceased partner's estate. But 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, steps should be taken to include a provision in the partnership agreement that requires continuation and that 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 the minor has significant involvement in the management of the partnership, the interest should probably be conveyed to a trustee for the minor's benefit, because the IRS regulations require adequate judicial supervision. A minor may, however, be a limited partner because limited partners are precluded from management. In any event, a gift of a partnership interest should be made in accordance with the Uniform Gift to Minors Act.

### **Retained Control**

Whether the parents should retain control of the partnership is usually anontax 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 in which capital is a substantial income-producing factor, such as one structured around family timberlands, will be recognized as a partner for income tax purposes whether the owner received the interest by purchase or gift. However, 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.

### **Limited Partnerships**

Limited partnerships are closer in structure to corporations than are general partnerships. A limited partnership may be organized in most States 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, but the price of this status is that a limited partner 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 certain family members, such as minors and distant co-owners, from management control. A limited partnership may also be useful if one of the partners, such as a parent, wishes to withdraw from active participation in management of the tree farm. It permits the parent to leave capital invested 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.

**Example 16.1.** Mr. and Mrs. Brown together own a substantial tree farm and have decided to utilize the annual gift exclusion in conjunction with a limited family partnership in order to lower the value of the timberland for estate and gift tax purposes. This procedure will allow the Browns to gradually transfer ownership of the timberland to their children but yet permit them to continue managing the property and make all the operating decisions. To implement the plan, the Browns first execute a limited partnership agreement in accordance with the law of their State, with themselves as general partners and the children as limited partners. Concurrently with establishment of the partnership, ownership of the tree farm is transferred to the partnership, with Mr. and Mrs. Brown each having a partnership interest equal to 50 percent of the tree farm's value. Beginning that year, and each year thereafter, the Browns gift to their children an interest in the partnership equal to or less than the annual gift tax exclusion. The value of the gifts can be substantially discounted because---for many years, at least--the Browns are giving their children minority interests in the partnership. Both Mr. and Mrs. Brown, or one of them, could be paid a salary or other compensation by the partnership for managing the tree farm from timber sale or other income received by the partnership. The Browns, as managing (general) partners, would determine how to distribute and/or invest the cash received by the partnership.





# Chapter 17

## Corporations

Closely held, family-owned tree farm corporations have increased in number during the past several decades in most States that have a substantial commercial timber acreage. Research findings indicate that estate planning considerations are a major reason for incorporation of nonindustrial tree farms. The corporate stock is typically owned by persons related by blood or marriage or both. Some nonindustrial woodland corporations are also owned by unrelated shareholders, most of these are small and closely held.

### CORPORATE FORMATION AND MANAGEMENT

A corporation is a distinct entity, separate from the shareholders who own it or from those who manage or work for it. Thus, a corporation can sue and be sued, enter into contracts, and own property--all in its own name. A corporation has most of the rights of an individual.

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; others can be added by the incorporators. Additional documents may also be required, 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 timber land 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

Probably 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 partnerships, shareholder personal assets--other than 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 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; and (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 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 permits shareholders to multiply their votes by the number of directors to be elected and cast the entire number for one director. It helps insure that minority shareholders will at least 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 decision makers. 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 tree farm is treated virtually the same with respect to expenditures as is a noncorporate timber ownership. Certain other aspects of corporate income taxation, however, differ from the rules applicable to individual woodland owners.

### 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 previously

permitted most taxpayers in a trade or business to immediately deduct rather than depreciate up to \$10,000 of otherwise depreciable costs per tax year. The 1993 Revenue Reconciliation Act raised the maximum Section 179 deduction to \$17,500 beginning in 1993. As under prior law, 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 \$200,000. For example, if \$210,000 of qualifying property were placed in service during the year, the maximum deduction under Section 179 would be \$16,500. With respect to corporations, members of a group of controlled corporations (discussed on page 109) divide the expensed amount. Normally, however, a family tree farm 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 tree farms will qualify for either method.

**"C" Corporation.**--If no Subchapter S election is made as discussed on page 109, a family woodland corporation will pay income tax under the regular method. Federal corporate tax rates were reduced in 1987 and increased slightly in 1993 by the 1993 Revenue Reconciliation Act. The current corporate rates are as follows:

Corporate taxable income	Marginal rate
0 - \$50,000	15 percent
\$50,000 - \$75,000	25 percent
\$75,000 - \$100,000	34 percent
over \$100,000	35 percent

An additional 5-percent surtax (for a maximum of \$11,750) is imposed on a corporation's taxable income above \$100,000. This provision will completely phase out the benefit of the 15- and 25-percent rates for corporations with taxable incomes of more than \$325,000. For corporations with taxable incomes between \$100,000 and \$335,000, the 15- and 25-percent rate benefits will be partially phased out. Corporations with taxable income above \$15 million also pay a 3-percent surtax on income above that amount to a maximum of \$100,000 extra tax. This recaptures the benefit of the 34-percent rate.

The attractiveness of the regularly taxed corporation is dependent on the relationship of corporate income tax rates to the rates applicable to individuals. The top individual marginal rate on ordinary income is currently 39.6 percent as compared to the top marginal corporate ordinary rate (including surtax) of 39 percent. Although this represents little difference, the spread between corporate and noncorporate long-term capital gains rates is considerably greater. The maximum long-term capital gain rate for individuals is 28 percent; for corporations it is 39 percent at income levels where the 5-percent surtax applies. This is particularly significant in the case of corporate family tree farms where, presumably, most of the income would be from timber sales and thus 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 save on income taxes for those shareholders whose individual rate is 28 or 31 percent, with respect to net income left in the corporation for business purposes or expansion. However, if the net earnings are removed from the corporation and paid to the shareholders as dividends, the shareholders will have to pay tax on the dividends received as ordinary income, 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 tree farm--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 rates ranging from 27 1/2 to 38 1/2 percent unless higher accumulations are justified as being retained for the reasonable needs of the business. For those woodland corporations investing in additional timberland, the \$250,000 level should pose no problem.

The Subchapter S corporation method of taxation was enacted in 1958 to remove the disadvantages of the regular corporate method of income taxation for small, family-owned corporations. If a corporation that meets the requirements (discussed on page 104) elects Subchapter S status by filing Form 2553 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 the shareholders are taxed and then on their individual returns. For all other purposes, however, a Subchapter S corporation remains identical to a "C" corporation.

A Subchapter S corporation passes through to its shareholders their pro rata share of capital gains and losses, operating losses, business deductions, depletion allowances, tax exempt interest, and credits. The pass through is on a daily basis. These items are then reported by the shareholders 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 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.

Distributions from a Subchapter S corporation can thus 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. 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.

**Shareholders.**--There can be no more than 35 shareholders. Stock owned by both spouses, regardless of how it is held or in whose name, is considered to be owned by only one shareholder. A surviving spouse and the estate of a deceased spouse are also treated as only a single 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 2 consecutive years. If it does, its Subchapter S status will be terminated. This rule could constitute a trap for the unwary Subchapter S tree farm that maintains an interest-bearing bank account in years in which no timber harvesting is done.

**Election.**--The election, as noted earlier, is made by filing Form 2553 with the IRS. It may be made at any time during the preceding taxable year, or on or before the 15th day of the 3d month of the taxable year in question. An election too late for 1 year may become effective the following year. All shareholders of record must consent to the election. It can be voluntarily revoked but only if the holders of more than half of the corporate stock consent to the revocation. Thus, a new shareholder by reason of gift or inheritance cannot unilaterally terminate the election, as was once allowed, unless he (she) owns a majority of the voting stock. The election can also 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 timber properties (Letter Ruling 9 111036). The corporation obtained a new treasurer in 1986 who was unaware of the Subchapter S election and, thus, began filing conventional "C" corporation tax returns. In addition, the corporation, through the treasurer, had violated the 25-percent passive income rule because no timber sales had been made for a number of years due to depressed prices, but yet 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 inadvertently terminated 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 such time as timber sales were resumed.

## ESTATE PLANNING CONSIDERATIONS

Certain characteristics of corporate ownership may enable it to more completely accomplish a forest landowner's estate planning objectives than will other forms of ownership. This is particularly true if the tree farm 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 tree farm, 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 by merely transferring shares of stock.

Parents who are sole owners or co-owners of forest property may be reluctant, for reasons of personal security, to make gifts of the property to the children in order to achieve death 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 are often unenforceable. Even if gifts are otherwise acceptable, however, donations of forest land are not easily made--either in terms of undivided interests or as separate parcels (see chapter 8).

On the other hand, transfer of corporate stock does not involve these disadvantages. Tree farm ownership

can be divided into easily transferred shares of stock so that the gift or sale of stock translates into a proportionate share of the tree farm. 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. This eases the income security problem. Restrictions can also be placed on the retransfer of stock by those receiving it through gift or sale. Stock can additionally be used to channel tree farm 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 timberland 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 tree farm. Minors, however, are not considered legally competent to manage their property. The transfers of property interests to minors have long created problems. Such gifts are usually 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. They basically 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, by contrast, are generally not eligible. An important consideration is that, if the donor is also 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 should probably be someone other than the donor.

**Unearned Income.**--Unearned income of a child under age 14 who has at least one living parent will be taxed at the parent's marginal income tax rate if the child's investment income is more than \$1,100 for the year. This rule may lessen the advantage of making transfers to young children.

### 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 is normally subject to probate--a process during which all assets are usually administered by the estate representative. Upon the death of a corporate shareholder, in contrast, 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 operation of the tree farm may be continued without interruption.

**Ancillary Probate.**--If an individual owns real property in two or more States, a probate proceeding is normally 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 real property is owned in two State(s) by a corporation, however, ancillary 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 15), which is generally available to joint tenants or tenants in common for terminating co-ownership arrangements, is not available to corporate shareholders. While those shareholders not actively participating in operation of the tree farm 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 corporate feature may cause disputes, however. Restrictions are often 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 tree farm 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 may 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, others cannot.

**Subchapter S Corporations.**--As discussed earlier, a Subchapter S corporation can have no more than 35 shareholders. If death and inheritance result in more than 35, 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 key estate planning devices (see chapter 10). 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 possible for stock in a Subchapter S corporation to be held by a marital deduction trust (see page 68).

## Adjustment of Basis

One corporate attribute that may prove to be a decided disadvantage with respect to tree farms concerns the basis of the land and timber. Assets held until death receive a new income tax basis, which is generally equal to the fair market value of the assets on the date of the decedent's death or 6 months after. This adjustment in basis cancels out any unrecognized gain or loss on the property and the new basis provides values (depletion values in the case of timber) for computing future gains or losses upon sale.

Thus, when a shareholder dies, the shares of stock owned at death receive a new income tax basis equal to their value as determined for death tax purposes. But the basis of the underlying property, such as land and timber, in the hands of the corporation remains unchanged. Therefore, the sale of timber by a corporation after the death of a shareholder creates the same amount of taxable gain or loss as if the timber had been sold before the shareholder died. Also, depreciable property already fully depreciated by the corporation may not be placed on a new depreciation schedule with a new income tax basis after a shareholder dies. These features of the corporation may

discourage incorporation by those older family members holding valuable timber assets that have a low basis.

**Complexities and Expenses.**--Incorporation is a more formal and complex method of organization than a partnership or sole proprietorship, and a corporation is more expensive to form 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 are usually deductible annually.

**Liquidation.**--A corporation may usually 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. Liquidating a corporation, however, without adverse income tax consequences is more difficult. 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.

## Revised Estate Plans

Upon formation of a corporation, 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 insure that the stock does not pass into a testamentary trust. If it does, the Subchapter S election will be lost after 60 days, and the corporation will revert to "C" corporation status and the double taxation rules.

## Chapter 18

### Limited Liability Companies

#### OVERVIEW

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. As of this writing, 28 States have enacted limited liability company statutes, as follows: Alabama (effective 10-1-93), Arkansas (effective 4-12-93), Arizona (effective 9-30-92), Colorado (effective 4-18-90), Delaware (effective 10-1-92), Florida (enacted 4-92), Georgia (effective 3-1-94), Idaho (effective 7-1-93), Illinois (effective 1-1-94), Indiana (effective 7-1-93), Iowa (effective 7-1-92), Kansas (effective 7-1-90), Louisiana (effective 7-7-92), Maryland (effective 10-1-92), Michigan (effective 6-1-93), Minnesota (effective 10-1-93), Montana (effective 10-1-93), Nebraska (effective 9-9-93), Nevada (effective 10-1-91), North Dakota (effective 7-1-93), Oklahoma (effective 9-1-92), Rhode Island (effective 9-19-92), South Dakota (effective 7-1-93), Texas (effective 9-1-91), Utah (effective 7-1-91), Virginia (effective 7-1-91), West Virginia (effective 3-6-92), and Wyoming (enacted 1977). In addition, authorizing legislation is pending in California, Massachusetts, New Jersey, New York, and Pennsylvania.

#### ORGANIZATION AND OPERATION

##### Articles of Organization

Instead of filing articles of incorporation, limited liability companies file articles of organization. These 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. Furthermore, creditors might try to reach the personal assets of the LLC's members as though they were partners in a partnership.

#### Members

An LLC is owned by its members, rather than by shareholders or partners. Generally, an LLC must have at least two members. This requirement is consistent with its classification for income tax purposes as a partnership. Although several States apparently permit only one member, it is likely that the Internal Revenue Service (IRS) would treat such an entity as a corporation rather than a sole proprietorship for tax purposes. A corporation, partnership, trust, estate, another LLC, or other legal entity, as well as an individual, may be a member. These coincide with the partnership classification rules of the Internal Revenue Code (IRC), which do not condition partnership status on the legal form of an entity's owners.

Contributions to an LLC in exchange for a membership interest may be made in the form of cash, property, the use of property, services, or any other valuable consideration. In some States, contributions may also 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 one and specify certain mandatory provisions. In the absence of an operating agreement, an LLC is governed by its articles and State law. Provisions concerning an LLC's affairs 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 LLC statute makes extensive use of default rules, which allow an LLC to be customized 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 of organization provide otherwise. An LLC that concentrates management authority in the hands of a few elected or appointed managers will be considered to have the corporate

characteristic of centralized management (see page 115) and could be treated as a corporation if it has other corporate attributes.

**Ownership Interests.**--Members of an LLC are usually permitted under State law 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 are generally made, and profits and losses allocated, on a proportional basis in accordance with the members' respective contributions.

**Withdrawals.**--Members of an LLC are also generally permitted under State law, unless otherwise provided in the articles or operating agreement, to withdraw on 6-months notice and receive the fair market value of their interests. 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. This requirement is usually imposed by State law so that the LLC will not have the corporate characteristic of continuity of life. An LLC can also 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 in whole or in part. The assignment entitles the assignee to receive to the extent assigned only the distributions to which the assignor would otherwise have been entitled. In most States, in order for an assignee to participate in an LLC's management and affairs and to exercise other membership rights, the remaining members must unanimously agree to the assignee's admission as a member. Although some State statutes may not prohibit 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, such a side agreement may cause an LLC to be classified as a corporation for Federal income tax purposes.

**Limited Liability.**--One of the key advantages of an LLC is that it provides limited liability to all of its members and managers. The typical State 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. This ability to insulate an LLC member from personal liability as a

member, regardless of management activities, is one of the chief distinctions between an LLC and a limited partnership. Some States permit a member to waive limited liability.

## TAX CONSIDERATIONS

A primary reason for using the limited liability company form of organization is to avoid the double taxation associated with a corporation but yet achieve pass-through taxation for the members and, at the same time, protect the members' personal assets from liability for the debts and obligations of the business.

### Corporate Attributes

The key to the favorable tax status of LLC's is that they are unincorporated business entities, and the IRS will not treat unincorporated entities as corporations unless they have more corporate than noncorporate characteristics. Internal Revenue Service Regulation 301.7701-2 lists four characteristics common to corporations but not to partnerships. The IRS will not impose corporate tax treatment unless the business entity has more than two of these. The four are: limited liability, continuity of life, free transferability of interests, and centralized management. Because limited liability is almost always present in an LLC, the test hinges on whether the LLC has more than one of the three remaining corporate attributes.

### Continuity of Life

An LLC lacks continuity of life if the death, retirement, mental incapacity, bankruptcy, or expulsion of any member causes the LLC to dissolve. In Revenue Ruling 88-76, the IRS determined that a Wyoming LLC lacked continuity of life because the State statutory provision requiring the LLC to be dissolved upon the occurrence of a withdrawal event, unless its business was continued by the unanimous consent of the remaining members, only established a mere contingent continuity of life. However, an outside agreement obligating a member to approve the continuation of the LLC's business upon either all or certain specified withdrawal events, or on the direction of another member or a certain percentage of the other members, may change this conclusion.

**Example 18.1.** Four related persons, each with an undivided interest in 1,500 acres of timberland in



Virginia, organized a limited liability company to manage the property. In Virginia, LLC's must dissolve upon the death, resignation, expulsion, bankruptcy, or other departure of a member, or upon the occurrence of any other event that terminates continued membership (other than assignment of the member's interest), unless all remaining members agree to continue the business. Therefore, this LLC lacks the corporate characteristic of continuity of life.

When a dissolution event occurs, LLC's no longer need the consent of all the remaining members to continue the business. The IRS has amended Regulation 301.7701-1(b)(1) so that continuity of life will be lacking as long as at least a majority of the LLC's members must consent to continuation of the business to prevent its dissolution. Although this change applies to tax years beginning on or after June 14, 1993, taxpayers also have the option of applying it to earlier years.

**Example 18.2.** A tree farm organized as an LLC has four members. One member holds 80 percent of the interests. The LLC has a provision in its articles of organization allowing dissolution, upon the loss of a member, to be prevented by a majority vote of the remaining members. This LLC has the corporate characteristic of continuity of life. It could allow members holding only a 20-percent interest to continue the LLC despite the inaction or objections of the 80-percent interest holder.

### Centralization of Management

A business entity has centralized management if one or more of its members, but fewer than all members, has (have) exclusive authority to make business decisions for the entity. Most State LLC statutes vest management authority in the hands of all members, unless the members choose to concentrate such authority with just a few of their number or hire nonmembers to manage the business. When all members--as a membership right--can exercise management authority to bind the LLC, the corporate characteristic of centralized management is lacking. Centralized management, however, is always present if State law requires the LLC members to elect managers to run the business and vests the managers with the managerial authority that most States reserve for the members (Revenue Ruling 93-6).

**Example 18.3.** The Silver Pines family tree farm LLC states that it is reserving management

authority for its members in the articles of organization filed with the State agency that regulates LLC's. However, the seven LLC members agree among themselves that only three of their number will actually manage the woodland. Nevertheless, State law binds the LLC for business or management actions taken by any of its members with third parties that do not have notice of the informal agreement. Because any of the LLC members could easily exercise binding management authority despite the informal agreement, the three designated managers lack the sole authority required for the corporate characteristic of centralized management.

### Free Transferability of Interests

An organization has the corporate characteristic of free transferability of interests if members owning substantially all of the interests in the organization can transfer all attributes of their interest to others without the consent of the rest of the members. However, interests are not deemed to be freely transferrable if only the right to share in profits can be assigned without consent, but not the right to participate in management. An LLC does not have the corporate characteristic of free transferability of interests if membership and related management rights cannot be transferred without the consent of the other members.

**Example 18.4.** The Lonesome Oak Tree Farm was organized with only two members, John and Peter. State law allows LLC members to freely transfer their income and capital interests, but their membership interest expires unless all the other members consent to the transfer to the third party. The Lonesome Oak Tree Farm lacks free transferability of interests, even though the consent of only one remaining LLC member (Peter) is needed in order for John to transfer half of his membership interest to his son.

### IMPLICATIONS FOR TIMBER PROPERTIES

The LLC represents the latest advance in the forms of business entities. An LLC that is classed as a partnership and which is assured of limited liability in all jurisdictions in which it will operate will combine ownership, operational, tax, and liability advantages in a way that neither the Subchapter S corporation nor the limited partnership can do. For family-owned tree

farms, the LLC certainly shows promise as an advantageous way to organize for current operations.

With respect to estate planning, the advantages are less clear. The restriction on transferability of interests could pose a problem in some situations. However, with a closely knit, family-owned tree farm, there may be no problem. The unanimous

consent of the members to give membership rights to an heir of a deceased member or donee of a living member may be easily obtainable. In considering whether to become an LLC, however, a family timber ownership should proceed with caution and with good professional advice. Because the LLC format is relatively new, its use still involves many uncertainties.

# Chapter 19

## State Death Tax Considerations

### TYPES OF STATE DEATH TAXES

The Federal estate tax liability may be readily deferred at the death of the first spouse by proper estate planning; however, State death taxes must still be considered. Three types of death taxes are levied by individual States. They are inheritance, estate, and piggy-back taxes.

#### Inheritance Tax

An inheritance tax is a levy on the right to receive property by individual heirs or legatees. The share value received by each individual beneficiary forms the basis for this tax. Currently, 18 States levy an inheritance tax (see table 19.1).

#### Estate Tax

An estate tax is a levy on the right to transfer property by the decedent's estate. Presently, the Federal government and four States levy an estate tax, five fewer States than in 1980 (see table 19.1).

#### Piggy-back Tax

A so-called "piggy-back tax" is equal to the State death tax credit allowable as a deduction against the Federal estate tax (see appendix, page 134). The piggy-back tax is now the most prevalent form of State death tax and is levied currently in 28 States (see table 19.1). A piggy-back levy does not result in any additional tax burden, but merely apportions the total tax burden between the Federal and State governments. In addition, Massachusetts is phasing in a piggy-back tax, which becomes effective in 1997.

#### Pickup-Tax

In the States that impose inheritance and estate taxes and the State death tax levy is less than the State death tax credit allowable as a Federal deduction, this additional, so-called "pick-up tax" absorbs the difference. Currently, 21 States have a pick-up tax (see table 19.1).

### Gift Tax

In addition to death taxes, six States also levy a gift tax (see table 19.1). Most of these States have incorporated the Federal gift tax provisions and, thus, tax gifts above the \$10,000 annual gift tax exemption per donee.

### Death Tax Provisions

Although there are only three basic forms of State death taxes (inheritance, estate, and piggy-back), the specific tax provisions vary greatly among the States. The allowable deductions, tax credits, exemption amounts, and tax rates depend on State law. The States with a piggy-back form of tax have levies that are based on the Federal return; therefore, the deductions, exemptions, rates, and credits will be the same in each of these States. However, the tax statutes of the 22 remaining States--those with inheritance and estate taxes--differ considerably, and require coordinated planning with the Federal provisions in order to obtain the best results.

Profound changes were introduced into the Federal unified estate and gift transfer taxes by the Economic Revenue Tax Act of 1981 and subsequent tax legislation. Many States have followed suit and changed their State statutes in order to move closer to the Federal tax model in form. For example, since 1980, States with an estate tax have decreased from 9 to 4; States with an inheritance tax have decreased from 30 to 18; and States with a piggy-back form of estate tax have increased to 28. State Departments of Revenue have cooperated closely with the Internal Revenue Service in the administration of these taxes.

### COMBINED FEDERAL-STATE TAX LIABILITY

Since the passage of the Economic Recovery Tax Act of 1981, substantial flexibility at the Federal level has been provided for forest landowners. However, State death taxes have often been overlooked. Effective estate planning requires consideration of both Federal and State taxes.

Table 19.1 .-State death and gift taxes in the United States, by region, 1993.

state	Type of Tax				
	Estate	Inheritance	Piggy-back	Pick-up	Gift
Northeastern region					
Connecticut		X		X	X
Delaware		X		X	X
Maine			X		
Maryland		X		X	
Massachusetts	X			X	
New Hampshire		X		X	
New Jersey		X		X	
New York	X			X	X
Ohio	X			X	
Pennsylvania		X		X	
Rhode Island			X		
Vermont			X		
West Virginia			X		
Southern region					
Alabama			X		
Arkansas			X		
Florida			X		
Georgia			X		
Kentucky		X		X	
Louisiana		X		X	X
Mississippi	X				
North Carolina		X		X	X
South Carolina			X		
Tennessee		X		X	X
Texas			X		
Virginia			X		
Midwestern region					
Illinois			X		
Indiana		X		X	

Table 19.1.-*State death and gift taxes in the United States, by region, 1993.--Continued*

State	Type of Tax				
	Estate	Inheritance	Piggy-back	pick-up	Gift
Northeastern region					
Iowa		X		X	
Kansas		X		X	
Michigan		X		X	
Minnesota			X		
Missouri			X		
Nebraska		X		X	
North Dakota			X		
Oklahoma		X		X	
South Dakota		X		X	
Wisconsin			X		
Western region					
Alaska			X		
Arizona			X		
California			X		
Colorado			X		
Hawaii			X		
Idaho			X		
Montana		X		X	
Nevada			X		
New Mexico			X		
Oregon			X		
Utah			X		
Washington			X		
Wyoming			X		

## **First Spouse to Die**

In the States with the piggy-back form of estate tax, effective use of the Federal unified credit of \$192,800 and the unlimited marital deduction to defer taxes on the estate of the first to die also accomplishes the same result at the State level. Therefore, if no Federal estate tax is due, then no State death tax will be due.

In States with estate and inheritance taxes, the allowable deductions may be quite different from the Federal deductions. Some States do not have a marital deduction; thus, the estate value deferred at the Federal level may be taxable by the State. In 1987, the State death tax for forested ownerships with gross estates ranging from \$600,000 to \$3,000,000 varied from 4 to 7 percent of the net taxable estate value, depending on the State in which the property was located, even though the Federal tax had been completely deferred.

**Special Use Valuation.**-- *The* advantages and disadvantages of electing special use valuation under Internal Revenue Code (IRC) Section 2032A at the Federal level are discussed in chapter 13. In 1993, special use valuation was indirectly available at the State level in the **28** States with a piggy-back tax law. It is also available in approximately one-half of the States with inheritance and estate tax laws by means of a special use valuation law at the State level. The remaining States with inheritance and estate tax laws either have no provisions for special use valuation or deny it explicitly.

**Deferral and Extension of Tax Payments.** -- *The* deferral and extension of Federal tax payments under IRC Section 6166 is discussed in chapter 14. At the State level, the 28 States with piggy-back tax laws permit deferral and extension indirectly when these are elected on the Federal return. Varying levels of extension and deferral are available in approximately two-thirds of the other States.

## **Second Spouse to Die**

At the death of the second spouse, effective estate planning at the Federal level has carried through to the State level for the 28 States with piggy-back tax laws. Assuming no remarriage, the unified credit is available to the estate of the second spouse to die, but there is no marital deduction to further defer the tax. Trusts, joint ownerships, aggressive gifting programs including charitable bequests, and other measures discussed elsewhere in this book provide mixed results in States with inheritance and estate taxes when the State death tax provisions are not explicitly incorporated in the planning process. These results occur because so much variability exists among the various State statutes and because some State statutes work counter to the Federal provisions. Thus, State law should be explicitly included in the timber estate planning process, especially in the 22 States that have either an inheritance or an estate tax law.

## **Appendixes**





## GLOSSARY

### A

**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 (collect assets of the estate, pay debts, distribute residue to those entitled to it) who (1) dies leaving no will, or (2) leaves a will naming an executor or executors who for some reason cannot serve.

**Administratrix**-The female counterpart of an administrator.

**Agent**-A person who acts for another person by the latter's authority.

**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 or 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, (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.

### B

**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.

### C

**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 as are 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 the shares of stock that have been issued, and that can own, receive, and transfer property, and carry on business in its own name.

**Curtesy**—A widower's legal interest in his wife's real estate.

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## D

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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.

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## E

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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 distribute the decedent's property in accordance with the will.

Executrix-The female counterpart of an executor.

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## F

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Fee simple-Absolute title to property with no limitations or restrictions regarding the person who may inherit it.

Fiduciary-A trustee, executor, or administrator.

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## G

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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 places property into and establishes a trust.

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 and managing the property of another person who, because of age, intellect, or health, is incapable of managing his/her own affairs.

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## H

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Heir-One entitled by law to inherit the property of a decedent who died without a will.

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## I

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**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.

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## J

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**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.

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## L

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**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.

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## M

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**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.

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## P

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**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.

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## R

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**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.

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## S

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**Sole ownership**—The type of property ownership in which one individual holds legal title to the property and has full control of it.

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## T

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**Tenancy in common**—The 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 and, upon death of one, the survivor acquires full title to the property.

**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.

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## W

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**Will**—A legal declaration of the manner in which a person wishes to distribute his (her) estate after death.

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## Appendix III

STATE DEATH TAX CREDIT <sup>1</sup>				
Estates of Decedents Dying After 1976				
Adjusted Taxable Estate ("Adjusted Taxable Estate" is the decedent's taxable estate less \$60,000)				
From	To	Credit =	+ %	Of Excess Over
0	\$40,000	0	0.8	0
\$40,000	90,000	0	1.6	\$40,000
90,000	140,000	\$400	2.4	90,000
140,000	240,000	1,200	3.2	140,000
240,000	440,000	3,600	4	240,000
440,000	640,000	10,000		440,000
640,000	840,000	18,000	4.8	640,000
840,000	1,040,000	27,600	5.6	840,000
1,040,000	1,540,000	38,800	6.4	1,040,000
1,540,000	2,040,000	70,800	7.2	1,540,000
2,040,000	2,540,000	106,800	8	2,040,000
2,540,000	3,040,000	146,800	8.8	2,540,000
3,040,000	3,540,000	190,800	6.6	3,040,000
3,540,000	4,040,000	238,800	10.4	3,540,000
4,040,000	5,040,000	290,800	11.2	4,040,000
5,040,000	6,040,000	402,800	12	5,040,000
6,040,000	7,040,000	522,800	12.8	6,040,000
7,040,000	8,040,000	650,800	13.6	7,040,000
8,040,000	9,040,000	786,800	14.4	8,040,000
9,040,000	10,040,000	930,800	15.2	9,040,000
10,040,000		1,082,800	16	10,040,000

<sup>1</sup> The above table may not be used in computing taxes on estates of certain servicemen.

<sup>2</sup> There is a limitation on the credit in estates of nonresidents not citizens dying after November 13, 1966. See Code Sec. 2102.





## **Appendix IV**



United States Estate (and Generation-Skipping Transfer)  
Tax ReturnEstate of a citizen or resident of the United States (see separate instructions). To be  
filed for decedents dying after October 8, 1990, and before January 1, 1993. For  
Paperwork Reduction Act Notice, see page 1 of the instructions.OMB No. 1545-0015  
Expires 6-30-93

Part 1.—Decedent and Executor	1a	Decedent's first name and middle initial (and maiden name, if any)		1b	Decedent's last name		2	Decedent's social security no.			
	3a	Domicile at time of death (county and state, or foreign country)			3b	Year domicile established	4	Date of birth	5	Date of death	
	6a	Name of executor (see instructions)			6b Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code)						
	6c	Executor's social security number (see instructions)									
	7a	Name and location of court where will was probated or estate administered							7b	Case number	
	8	If decedent died testate, check here <input type="checkbox"/> and attach a certified copy of the will.							9	If Form 4768 is attached, check here <input type="checkbox"/>	
	10	If Schedule R-1 is attached, check here <input type="checkbox"/>									
	Part 2.—Tax Computation	1	Total gross estate (from Part 5, Recapitulation, page 3, item 10)						1		
		2	Total allowable deductions (from Part 5, Recapitulation, page 3, item 20)						2		
		3	Taxable estate (subtract line 2 from line 1)						3		
4		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)))						4			
5		Add lines 3 and 4						5			
6		Tentative tax on the amount on line 5 from Table A in the instructions.						6			
7a		If line 5 exceeds \$10,000,000, enter the lesser of line 5 or \$21,040,000. If line 5 is \$10,000,000 or less, skip lines 7a and 7b and enter -0- on line 7c.						7a			
b		Subtract \$10,000,000 from line 7a						7b			
c		Enter 5% (.05) of line 7b						7c			
8		Total tentative tax (add lines 6 and 7c)						8			
9		Total gift tax 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)						9			
10		Gross estate tax (subtract line 9 from line 8)						10			
11		Maximum unified credit against estate tax						11	192,800	00	
12		Adjustment to unified credit. (This adjustment may not exceed \$6,000. See instructions.)						12			
13		Allowable unified credit (subtract line 12 from line 11).						13			
14		Subtract line 13 from line 10 (but do not enter less than zero)						14			
15		Credit for state death taxes. Do not enter more than line 14. Compute the credit by using the amount on line 3 less \$80,000. See Table B in the instructions and attach credit evidence (see instructions)						15			
16		Subtract line 15 from line 14						16			
17		Credit for Federal gift taxes on pre-1977 gifts (section 1212) (attach computation)						17			
18		Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706CE)						18			
19		Credit for tax on prior transfers (from Schedule Q)						19			
20		Total (add lines 17, 18, and 19)						20			
21		Net estate tax (subtract line 20 from line 16)						21			
22		Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)						22			
23		Section 4980A increased estate tax (from Schedule S, Part I, line 17) (see instructions)						23			
24		Total transfer taxes (add lines 21, 22, and 23)						24			
25		Prior payments. Explain in an attached statement						25			
26		United States Treasury bonds redeemed in payment of estate tax						26			
27	Total (add lines 25 and 26)						27				
28	Balance due (or overpayment) (subtract line 27 from line 24).						28				

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.

Signature(s) of executor(s)

Date

Signature of preparer other than executor

Address (and ZIP code)  
Cat. No. 20548R

Date



**Estate of:****Part 3.-Elections by the Executor****Please check the "Yes" or "No" box for each question.**

	Yes	No
1 Do you elect alternate valuation?		
2 Do you elect special use valuation? If "Yes," you must complete and attach Schedule A-1		
3 Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described in the instructions.		
4 Do you elect to postpone the part of the taxes attributable to a reversionary or remainder interest as described in section 6163?		

**Part 4.-General Information** (Note: Please attach the necessary supplemental documents. You must attach the death certificate.)

Authorization to receive confidential tax information under Regulations section 601.502(c)(3)(ii), to act as the estate's representative before the Internal Revenue Service, 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"/> 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 ► .....

4a Surviving spouse's name	4b Social security number	4c Amount received (see instructions)
----------------------------	---------------------------	---------------------------------------

5 Individuals (other than the surviving spouse), trusts, or other estates who receive benefits from the estate (do not include charitable beneficiaries shown in Schedule O) (see instructions). For Privacy Act Notice (applicable to individual beneficiaries only), see the Instructions for Form 1040.

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 ..... ►

T o t a l

(Continued on next page)

## Part 4.—General information (continued)

Please check the "Yes" or "No" box for each question.		Yes	No
6	Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate) (see instructions)?		
7a	Have Federal gift tax returns ever been filed? If "Yes," please attach copies of the returns, if available, and furnish the following information:		
7b	Period(s) covered		
7c	Internal Revenue office(s) where filed		
<b>If you answer "Yes" to any of questions 8–16, you must attach additional information as described in the instructions.</b>			
8a	Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?		
b	Did the decedent own any insurance on the life of another that is not included in the gross estate?		
9	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which (a) one or more of the other joint tenants was someone other than the decedent's spouse, and (b) less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E.		
10	Did the decedent, at the time of death, own any interest in a partnership or unincorporated business or any stock in an inactive or closely held corporation?		
11	Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G)? If "Yes," you must complete and attach Schedule G.		
12	Were there in existence at the time of the decedent's death: a Any trusts created by the decedent during his or her lifetime? b Any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		
13	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H.		
14	Was the marital deduction computed under the transitional rule of Public Law 97-34, section 403(e)(3) (Economic Recovery Tax Act of 1981)? If "Yes," attach a separate computation of the marital deduction, enter the amount on item 18 of the Recapitulation, and note on item 18 "computation attached."		
15	Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I? If "Yes," you must complete and attach Schedule I.		
16	Did the decedent have a total "excess retirement accumulation" (as defined in section 4980A(d)) in qualified employer plans and individual retirement plans? If "Yes," you must complete and attach Schedule S.		

## Part 5.—Recapitulation

Item number	Gross estate	Alternate value	Value at date of death
1	Schedule A—Real Estate		
2	Schedule B—Stocks and Bonds		
3	Schedule C—Mortgages, Notes, and Cash		
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)		
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)		
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)		
7	Schedule G—Transfers During Decedent's Life (attach Form(s) 712 for life insurance)		
8	Schedule H—Powers of Appointment		
9	Schedule I—Annuities		
10	Total gross estate (add items 1 through 9). Enter here and on line 1 of the Tax Computation		
Item number	Deductions	Amount	
11	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims		
12	Schedule K—Debts of the Decedent		
13	Schedule K—Mortgages and Liens		
14	Total of items 11 through 13.		
15	Allowable amount of deductions from item 14 (see the instructions for item 15 of the Recapitulation)		
16	Schedule L—Net Losses During Administration		
17	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims		
18	Schedule M—Bequests, etc., to Surviving Spouse		
19	Schedule O—Charitable, Public, and Similar Gifts and Bequests		
20	Total allowable deductions (add items 15 through 19). Enter here and on line 2 of the Tax Computation		

**Estate of:****SCHEDULE A-Real Estate***(For jointly owned property that must be disclosed on Schedule E, see the instructions for 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 2047 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 schedule(s) (or additional sheet(s)) attached to this schedule.				
TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 1.) .				

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
 (See the instructions on the reverse side.)

**Schedule A-Page 4**

**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 the alternate valuation is not adopted; the date of death is January 1, 1991.

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 \$2,700 due at end of each quarter, February 1, May 1, August 1, and November 1. Value based on appraisal, copy of which is attached.			108,000
	Rent due on item 1 for quarter ending November 1, 1990, but not collected at date of death.			2,700
	Rent accrued on item 1 for November and December 1990			1,800
2	House and lot, 304 Jefferson Street, Alexandria, VA (lot 18, square 40). Rent of \$600 payable monthly. Value based on appraisal, copy of which is attached.			96,000
	Rent due on item 2 for December 1990, but not collected at date of death			600

In this example alternate valuation is adopted; the date of death is January 1, 1991.

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 \$2,700 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.	7/1/91	90,000	108,000
	Rent due on item 1 for quarter ending November 1, 1990, but not collected until February 1, 1991.	2/1/91	2,700	2,700
	Rent accrued on item 1 for November and December 1990, collected on February 1, 1991.	2/1/91	1,800	1,800
2	House and lot, 304 Jefferson Street, Alexandria, VA (lot 18, square 40). Rent of \$600 payable monthly. Value based on appraisal, copy of which is attached. Property exchanged for farm on May 1, 1991.	5/1/91	90,000	96,000
	Rent due on item 2 for December 1990, but not collected until February 1, 1991	2/1/91	600	600

Schedule A-Page 5



Checklist for Section **2032A** Election-/f you are going to make the special use valuation election on Schedule A-I, 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-I, Part 2), and (b) a fully executed agreement (Schedule A-I, 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 (a) did not 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-I, 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?





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

6 Were there any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family:..

	Yes	No
a Did not own the property listed on line 2 above? . . . . .		
b Did not use the property listed on line 2 above in a qualified use? . . . . .		
c Did not materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6)? . . . . .		

If "Yes" to any of the above, you must attach a statement listing the periods. If applicable, describe whether the exceptions of sections 2032A(b)(4) or (5) are met.

9 Attach affidavits describing the activities constituting material participation and the identity and relationship to the decedent of the material participants.

**10 Persons holding interests.** Enter the requested information for each **party who** received any interest in the specially valued property.

	Name	Address		
<b>A</b>				
<b>B</b>				
<b>C</b>				
<b>D</b>				
<b>E</b>				
<b>F</b>				
<b>G</b>				
<b>H</b>				
	Identifying number	Relationship to decedent	Fair market value	Special use value
<b>A</b>				
<b>B</b>				
<b>C</b>				
<b>D</b>				
<b>E</b>				
<b>F</b>				
<b>G</b>				
<b>H</b>				

**You must attach a computation of** the GST tax savings attributable to direct skips **for** each person listed above who is a skip person. (See instructions.)

**11 Woodlands election.-Check here** ☐ if you wish to make a woodlands election as described in section 2032A(e)(13). Enter the Schedule and item numbers from Form 706 of the property for which you are making this election **▶** \_\_\_\_\_  
You must attach a statement explaining why you are entitled to make this election. The IRS may issue regulations that require more information to substantiate this election. You will be notified by the IRS if you must supply further information.

# Part 3.-Agreement to Special Valuation Under Section 2032A

Estate of:	Date of Death	Decedent's Social Security Number
------------	---------------	-----------------------------------

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 line 2 of Part 2 of Schedule A-I of Form 706, 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 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**, United States Additional Estate Tax Return, 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 63246 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 63248. 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 authority includes the following:

- 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 63248.
- To furnish the Service with any requested information concerning the property.
- To notify the 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.
- To execute closing agreements under section 7121.
- Other acts (specify) ► \_\_\_\_\_

By signing this agreement, the agent agrees to provide the Service with any requested information concerning this property and to notify the Service of any disposition or cessation of the qualified use of any part of this property.

Name of Agent	Signature	Address
---------------	-----------	---------

The property to which this agreement relates is listed in Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and in the Notice of Election, along with its fair market value according to section 2031 of the Code and its special use value according to section 2032A. The name, address, social security number, and interest (including the value) of each of the undersigned in this property are as set forth in the attached Notice of Election.

IN WITNESS WHEREOF, the undersigned have hereunto set their hands at \_\_\_\_\_  
this \_\_\_\_\_ day of \_\_\_\_\_

Qualified Heirs \_\_\_\_\_

Other Interested Parties \_\_\_\_\_

**Schedule A-I--Page 9**

## Instructions for Schedule A-I.-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 line 2 of Part 3. Elections by the Executor, Form 706. Schedule A-I 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-I 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 I.-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 line 2 of Part 3, Elections by the Executor, you must check this box, enter the decedent's name and social security number in the spaces provided at the top of Schedule A-I, and complete line 1 and column A of lines 3 and 4 of Part 2. 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-D of lines 3 and 4. You need not complete any other line entries on Schedule A-I. Completing Schedule A-I as described above constitutes a Notice of Protective Election as described in Regulations section 20.2032A-8(b).

### Part P.-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-I. 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-I 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-I, show these interests on the Schedule R, Parts 2 and 3 worksheets, as appropriate. Do not use Schedule R-I as a worksheet.

**Completing the Special Use Value Worksheets.**-On lines 2-4 and 6, enter -0-.

**Completing the Fair Market Value Worksheets.**-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-.

**Line 6—GST exemption**-If you completed line 10 of Schedule R, Part 1, 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 line 10 of Schedule R, Part 1, 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.

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 where needed for identification. Give CUSIP number if available.	Unit value	Alternate valuation date	Alternate value	Value at date of death
1					
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule.					
TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 2.)					

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
 (The instructions to Schedule B are in the separate instructions.)

**Schedule B-Page 11**





Estate of:

**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 schedule(s) (or additional sheet(s)) 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.)

**Schedule C-Page 12**

## Instructions for Schedule C.— Mortgages, Notes, and Cash

If the total gross estate contains any mortgages, notes, or cash, you must complete Schedule C and file it with the return.

On Schedule C list mortgages and notes payable to the decedent at the time of death. (Mortgages and notes *payable by* the decedent should be listed (if deductible) on Schedule K. Also list on Schedule C cash the decedent had at the date of death.

Group the items in the following categories and list the categories in the following order:

1. **Mortgages**-List: (a) the face value and unpaid balance; (b) date of mortgage; (c) date of maturity; (d) name of maker; (e) property mortgaged; and (f) interest dates and rate of interest. For example: bond and mortgage of \$50,000, unpaid balance \$24,000; dated January 1, 1980; John Doe to Richard Roe; premises 22 Clinton Street, Newark, N.J.; due January 1, 1992, interest payable at 10% a year January 1 and July 1.

2. **Promissory notes**.-Describe in the same way as mortgages.

3. **Contract by the decedent to sell land**.-List: (a) the name of the purchaser; (b) date of contract; (c) description of property; (d) sale price; (e) initial payment; (f) amounts of installment payment; (g) unpaid balance of principal; and (h) interest rate.

4. **Cash in possession**.-List separately from bank deposits.

5. **Cash in banks, savings and loan associations, and other types of financial organizations**.-List: (a) the name and address of each financial organization; (b) amount in each account; (c) serial number; and (d) nature of account, indicating whether checking, savings, time deposit, etc. If you obtain statements from the financial organizations, keep them for IRS inspection.

Estate of:

SCHEDULE D-Insurance on the Decedent's Life

You must attach a Form 712 for each policy.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule				
TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 4.).				

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(See the instructions on the reverse side.)

## Instructions for Schedule D.-Insurance on the Decedent's Life

If 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;
- 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:

- Name of the insurance company and
- 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.

Estate of:

**SCHEDULE E-Jointly Owned Property**

(If you elect section 2032A valuation, you must complete Schedule E and Schedule A-1.)

**PART I.-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 available.	Alternate valuation date	Alternate value	Value at date of death
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule. . . . .				
<b>la Totals</b> . . . . .				
<b>lb</b> Amounts included in gross estate (one-half of line la) . . . . .				

**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)
A.	
B.	
C.	

Item number	Enter letter for co-tenant	Description (including alternate valuation date if any) For securities, give CUSIP number, if available.	Percentage includible	Includible alternate value	Includible value at date of death
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule.					
<b>2b Total other joint interests</b> . . . . .					
<b>3 Total</b> includible joint interests (add lines 1 b and 2b). Also enter on Part 5, Recapitulation, page 3, at item 5. . . . .					

(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.)**Schedule E-Page 16**

## Instructions for Schedule E.-Jointly Owned Property

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."

**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.—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.

Estate of:

**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 articles of artistic or 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.		
<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.		
<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.

Item number	Description For securities, give CUSIP number, if available.	Alternate valuation date	Alternate value	Value at date of death
<b>1</b>				
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule.				
TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 6.) . . . .				

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(See the instructions on the reverse side.)

Schedule F-Page 18

## 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
- 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 56 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
- 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
- Automobiles

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. 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.

**Line 1.—**If the decedent owned at the date of death articles with artistic or intrinsic value (e.g., 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 article 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)).



**Estate of:** \_\_\_\_\_**SCHEDULE G-Transfers During Decedent's Life***(If you elect section 2032A valuation, you must complete Schedule G and Schedule A-I.)*

Item number	Description For securities, give CUSIP number, if available.	Alternate valuation date	Alternate value	Value at date of death
<b>A.</b>	Gift tax paid 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(c)) . . . . .	X X X X X		
<b>B.</b>	Transfers includible under section 2035(a), 2036, 2037, or 2038:			
1				
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule . . .				
<b>TOTAL.</b> (Also enter on Part 5, Recapitulation, page 3, at item 7.). . . . .				

**SCHEDULE H-Powers of Appointment***(If you elect section 2032A valuation, you must complete Schedule H and Schedule A-I.)*

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedule(s) (or additional sheet(s)) 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.)

**Schedules G and H-Page 20**

Estate of:

**SCHEDULE I-Annuities***Note: Generally, no exclusion is allowed for the estates of decedents dying after December 31, 1984 (see instructions).*

A Are you excluding from the decedent's gross estate the value of a lump-sum distribution described in section 2039(f)(2)? . . . . .

If "Yes," you must attach the information required by the instructions.

Yes	No
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Item number	Description Show the entire value of the annuity before any exclusions.	Alternate valuation date	Includible alternate value	Includible value at date of death
1				
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule .				
<b>TOTAL.</b> (Also enter on Part 5, Recapitulation, page 3, at item 9). . . . .				

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
 (The instructions to Schedule I are in the separate instructions.)

**Schedule I-Page 21**

**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
<b>1</b>	<b>A. Funeral expenses:</b>		
	Total funeral expenses. . . . .		
	<b>B. Administration expenses:</b>		
<b>1</b>	Executors' commissions-amount estimated/agreed upon/paid. (Strike out the words that do not apply.)		.....
<b>2</b>	Attorney fees-amount estimated/agreed upon/paid. (Strike out the words that do not apply.)		.....
<b>3</b>	Accountant fees-amount estimated/agreed upon/paid. (Strike out the words that do not apply.)		
<b>4</b>	Miscellaneous expenses:	Expense amount	
	Total miscellaneous expenses from continuation schedule(s) (or additional sheet(s)) attached to this schedule. . . . .		
	Total miscellaneous expenses . . . . .		
	<b>TOTAL.</b> (Also enter on Part 5, Recapitulation, page 3, at item 11.) . . . . .		

(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.)

**Schedule J-Page 22**

## 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 11 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.**

### **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 District Director 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;
- 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 District Director 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.

Estate of:

**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 schedule(s) (or additional sheet(s)) attached to this schedule .....				

**TOTAL.** (Also enter on Part 5, Recapitulation, page 3, at item 12.) .....

Item number	Mortgages and Liens—Description	Amount
1		
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule .....		
<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.)  
 (The instructions to Schedule K are in the separate instructions.)

**Schedule K -Page 24**

Estate of:

**SCHEDULE L-Net Losses During Administration and  
Expenses Incurred in Administering Property Not Subject to Claims**

Item numb	Net losses during administration ( <i>Not: Do not deduct losses claimed on a Federal income tax return.</i> )	Amount
1		
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule ...		
TOTAL. (Also enter on Part 5. Recapitulation, page 3, at item 16.) ...		

Item numbe	Expenses incurred in administering property not subject to claims (Indicate whether estimated agreed upon, or paid.)	Amount
1		
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule ..		
TOTAL. (Also enter on Part 5, Recapitulation, page 3, at item 17.) .		

(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 L are in the separate instructions.)

**Schedule L -Page 25**

**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 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).

	Yes	No
1 Did any property pass to the surviving spouse as a result of a qualified disclaimer? ..... If "Yes," attach a copy of the written disclaimer required by section 2518(b).		
2a In what country was the surviving spouse born? _____		
b What is the surviving spouse's date of birth? _____		
c Is the surviving spouse a U.S. citizen? . . . . .		
d If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship? _____		
e If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen? _____		
3 Qualified Domestic Trust-Do you elect under section 2056A(d) to treat any trusts reported on Schedule M as qualified domestic trusts? (identify in the description column on Schedule M below the trusts to which the QDT election applies) (see instructions). . . . .		
4 Election out of QTIP Treatment of Annuities-Do you elect under section 2056(b)(7)(C)(ii) not to treat as qualified terminable interest property any joint and survivor annuities that are included in the gross estate and would otherwise be treated as qualified terminable interest property under section 2056(b)(7)(C)? (see instructions)		

Item number	Description of property interests passing to surviving spouse	Amount
1		

Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule . . . . .

5	Total amount of property interests listed on Schedule M . . . . .	5
6a	Federal estate taxes (including section 4980A taxes) payable out of property interests listed on Schedule M . . . . .	6a
b	Other death taxes payable out of property interests listed on Schedule M . . . . .	6b
c	Federal and state GST taxes payable out of property interests listed on Schedule M . . . . .	6c
d	Add items a, b, and c . . . . .	6d
7	Net amount of property interests listed on Schedule M (subtract 6d from 5). Also enter on Part 5, Recapitulation, page 3, at item 18 . . . . .	7

(If more space is needed, attach the continuation schedule from the end of this package of additional sheets of the same size.)

**Schedule M-Page 26**

## Examples of Listing of Property Interests on Schedule M

Item number	Description of property interests passing to surviving spouse	Amount
1	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, 1937 (Schedule E, Part I, item 1) . . . . .	\$ 32,500
2	Proceeds of Gibraltar Life Insurance Company policy No. 104729, payable in one sum to surviving spouse (Schedule D, item 3) . . . . .	20,000
3	Cash bequest under Paragraph Six of will . . . . .	100,000

### 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 item 18 of Part 5, Recapitulation.

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" 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 for line 3 on the following page for details on the election.*

**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).

**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).

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*, and should not be entered on Schedule M (unless you are making a QTIP election) 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 in 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 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 on the following page 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 line 6 of General Information 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** 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.

The QTIP election may be made for all or any part of a 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 sections 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 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.**

**Line X-Qualified Domestic Trust Election.-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" (QDT) or if such property is transferred or irrevocably assigned to a QDT before the decedent's estate tax return is filed.**

A QDT is any trust:

1. That requires at least one trustee to be either an individual who is a citizen of the U.S. 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 QDT;
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.

To make the election, you must answer "Yes" to the question on line 3. **Once made, the election is irrevocable.**

When listing property on Schedule M, identify that property for which the QDT election has been made. Include the employer identification number for each trust and the names and addresses of all trustees.

The determination of whether a trust qualifies as a QDT 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 QDT requirements, then the determination will not be made until the court ordered changes to the trust are made.

**Line 4.**—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 4. 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 4, 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.

**How To Complete 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.

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.

- Any other important information such as that relating to any claim to any part of the estate not arising under the will.

**Lines 6a, b, and c.**—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 lines 6b or 6c, identify the taxes and attach your computation of them. For additional information, see **Pub. 904**, *Interrelated Computations for Estate and Gift Taxes*.

**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 District Director may request other evidence to support the marital deduction claimed.

Estate of:

**SCHEDULE O-Charitable, Public, and Similar Gifts and Bequests**

		Yes	No
1a 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.			
b According to the information and belief of the person or persons filing this return, is any such action planned? . If "Yes," full details must be submitted with this schedule.			
2 Did any property pass to charity as the result of a qualified disclaimer? . . . . . If "Yes," attach a copy of the written disclaimer required by section 2518(b)			
Item number	Name and address of beneficiary	Character of institution	Amount
1			
Total from continuation schedule(s) (or additional sheet(s)) attached to this schedule . . . . .			
3 Total . . . . .		3	
4a Federal estate tax (including section 4980A taxes) payable out of property interests listed above . . . . .		4a	
b Other death taxes payable out of property interests listed above . . . . .		4b	
c Federal and state GST taxes payable out of property interests listed above.		4c	
d Add items a, b, and c. . . . .		4d	
5 Net value of property interests listed above (subtract 4d from 3). Also enter on Part 5, Recapitulation, page 3, at item 19 . . . . .		5	

(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.)

**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)

**2** Value of the gross estate (adjusted, if necessary, according to the instructions for item 2)

**3** Value of property situated in that country, subjected to death taxes imposed in that country, and included in the gross estate (adjusted, if necessary, according to the instructions for item 3) . . .

**4** Tax Imposed by section 2001 reduced by the total credits claimed under sections 2010, 2011, and 2012 (see Instructions)

**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.) .

**6** Credit for death taxes imposed in the country named above (the smaller of item 1 or item 5). Also enter on line 18 of Part 2, Tax Computation . . . . .

**SCHEDULE Q-Credit for Tax on Prior Transfers****Part 1 .-Transferor Information**

	Name of transferor	Social security number	IRS office where estate tax return was filed	Date of death
A				
B				
C				

Check here ☐ if section 2013(f) (special valuation of farm, etc., real property) adjustments to the computation of the credit were made (see instructions).

**Part 2.-Computation of Credit (see instructions)**

Item	Transferor			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 2 0 )				
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 19 of Part 2, Tax Computation . . . . .				

(The instructions to Schedules P and Q are in the separate instructions.)

**Schedules P and Q-Page 31**

**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 2672 even if the form is not required to be filed to report estate or GST tax.

**Part 1.—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) (Special QTIP) Election**

Check box ☐ if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

1	Maximum allowable GST exemption.	1	\$1,000,000
2	Total GST exemption allocated by the decedent against decedent's lifetime transfers.	2	
3	Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers.	3	
4	GST exemption allocated on line 6 of Schedule R, Part 2.	4	
5	GST exemption allocated on line 6 of Schedule R, Part 3.	5	
6	Total GST exemption allocated on line 4 of Schedule(s) R-I ....	6	
7	Total GST exemption allocated to inter vivos transfers and direct skips (add lines 2-6)	7	
8	GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1).	8	
9	Allocation of GST exemption to trusts (as defined for GST tax purposes):		

A Name of trust	B Trust's EIN (if any)	C GST exemption allocated on lines 2-6, above (see instructions)	D Additional GST exemption allocated (see instructions)	E Trust's inclusion ratio (optional—see instructions)

**9D Total.** May not exceed line 8, above **9D**

**10** GST exemption available to allocate to section 2032A interests received by individual beneficiaries (subtract line 9D from line 8). You must attach special use allocation schedule (see instructions)

**10**

(The instructions to Schedule R are in the separate instructions.)

**Schedule R-Page 32**

**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 2.818182). . . . .	8	
9	Enter the amount from line 8 of Schedule R, Part 3. . . . .	9	
10	<b>Total GST taxes payable by the estate. (Add lines 8 and 9.)</b> Enter here and on line 22 of the Tax Computation on page 1	10	

### Part 3.-Direct Skips Where the Property Interests Transferred Do Not Bear the GST Tax on the Direct Skips

<b>1</b> Total estate tax values of all property interests listed above . . . . .	<b>1</b>	
<b>2</b> Estate taxes, state death taxes, and other charges borne by the property interests listed above . . . . .	<b>2</b>	
<b>3</b> 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>	
<b>4</b> Total fixed taxes and other charges. (Add lines 2 and 3.) . . . . .	<b>4</b>	
<b>5</b> Total tentative maximum direct skips. (Subtract line 4 from line 1.) . . . . .	<b>5</b>	
<b>6</b> GST exemption allocated . . . . .	<b>6</b>	
<b>7</b> Subtract line 6 from line 5 . . . . .	<b>7</b>	
<b>8</b> GST tax due (multiply line 7 by .55). Enter here and on Schedule R, Part 2, line 9. ....	<b>8</b>	







## Instructions for Fiduciary

### Purpose of Schedule R-I

Code section 2603(a)(2) provides that the Generation-Skipping Transfer (GST) tax imposed on a direct skip from a trust is to be paid by the trustee. Schedule R-I (Form 706) serves as a payment voucher for the trustee to remit the GST tax to the IRS. See the instructions for Form 706 as to when a direct skip is from a trust.

### How To Pay the GST Tax

The executor will compute the GST tax, complete Schedule R-I, and give you two copies. You should pay the GST tax using one copy and keep the other copy for your records.

The GST tax due is the amount shown on line 6. Make your check or money order for this amount payable to "Internal Revenue Service," write "GST tax" and the trust's EIN on it, and send it and one copy of the completed Schedule R-I to the IRS Service Center where the Form 706 was filed, as shown on the front of the Schedule R-I.

### When To Pay the GST Tax

The GST tax is due and payable 9 months after the decedent's date of death (entered by the executor on Schedule R-I). Interest will be charged on any GST taxes unpaid as of that date. However, you have an automatic extension of time to file Schedule R-I and pay the GST tax due until 2 months after the due date (with extensions) for filing the decedent's Schedule R, Form 706. This Schedule R, Form 706 due date is entered by the executor on Schedule R-I. Thus, while interest will be due on unpaid GST taxes, no penalties will be charged if you file Schedule R-I by this extended due date.

### Signature

**You**, as fiduciary, must sign the Schedule R-I in the space provided.

Estate of:

**SCHEDULE S-Increased Estate Tax on Excess Retirement Accumulations**

(Under section 4980A(d) of the Internal Revenue Code)

**Part I Tax Computation**1 Check this box if a section 4980A(d)(5) spousal election is being made. . . . . ☐**You** must attach the statement described in the instructions.

2 Enter the name and employer identification number (EIN) of each qualified employer plan and individual retirement account in which the decedent had an interest at the time of death:

	Name	EIN
Plan #1		
Plan #2		
Plan #3		
IRA #1		
IRA #2		
IRA #3		

	A Plan #1	B Plan #2	C Plan #3	D All IRAs
3 Value of decedent's interest .				
4 Amounts rolled over after death . . . .				
5 Total value (add lines 3 and 4) .				
6 Amounts payable to certain alternate payees (see instructions) . .				
7 Decedent's investment in the contract under section 72(f)				
6 Excess life insurance amount.				
9 Decedent's interest as a beneficiary.				
10 Total reductions in value (add lines 6, 7, 8, and 9)				
11 Net value of decedent's interest (subtract line 10 from line 5) . . . .				
12 Decedent's aggregate interest in all plans and IRAs (add columns A-D of line 11) ▶				12
13 Present value of hypothetical life annuity (from Part III, line 4) .	13			
14 Remaining unused grandfather amount (from Part II, line 4)	14			
15 Enter the greater of line 13 or line 14 . . . . .				15
16 Excess retirement accumulation (subtract line 15 from line 12).				16
17 Increased estate tax (multiply line 16 by 15%). Enter here and on line 23 of the Tax Computation on page 1				17

(The instructions to Schedule S are in the separate instructions.)

**Part II** Grandfather Election

- 1** Was a grandfather election made on a previously filed Form 5329? . . . . . ☐ Yes ☐ No  
 If "Yes," complete lines 2-4 below. You may not make or revoke the grandfather election after the due date (with extensions) for filing the decedent's 1988 income tax return. If "No," enter -0- on line 4 and skip to Part III.

<b>2</b> Initial grandfather amount . . . . .	<b>2</b>	
<b>3</b> Total amount previously recovered . . . . .	<b>3</b>	
<b>4</b> Remaining unused grandfather amount (subtract line 3 from line 2). Enter here and on Part I, line 14, on page 37. . . . .	<b>4</b>	

**Part III** Computation of Hypothetical Life Annuity

<b>1</b> Decedent's attained age at date of death (in whole years, rounded down) . . . . .	<b>1</b>	
<b>2</b> Applicable annual annuity amount (see instructions). . . . .	<b>2</b>	
<b>3</b> Present value multiplier (see instructions) . . . . .	<b>3</b>	
<b>4</b> Present value of hypothetical life annuity (multiply line 2 by line 3). Enter here and on Part I, line 13, on page 37. . . . .	<b>4</b>	

Estate of:

**CONTINUATION SCHEDULE**

Continuation of Schedule (Enter number of schedule you are continuing)

Item numbe	Description For securities, give CUSIP number, if available.	Unit value Sch B or E only	Alternate valuation date	Alternate value	Value at date of death or amount deductible
TOTAL. (Carry forward to main schedule.) . . . . .					

**See the instructions on the reverse side.**

Continuation Schedule-Page 39

## Instructions for Continuation Schedule

The Continuation Schedule on page 39 provides a uniform format for listing additional **assets** from Schedules A, B, C, D, **E**, **F**, G, H, and **I** and additional deductions from Schedules J, K, L, M, and **O**. Use the Continuation Schedule when you need to list more assets or deductions than you have room for on one of the main schedules.

Use a separate Continuation Schedule for each main schedule you are continuing. For each schedule of Form 706, you may use as many Continuation Schedules as needed to list all the assets or deductions to be reported. Do not combine assets or deductions from different schedules on one Continuation Schedule. Because there is only one Continuation Schedule in this package, you should make copies of the schedule before completing it if you expect to need more than one.

Enter the letter of the schedule you are continuing in the space provided at the top of the Continuation Schedule. Complete the rest of the Continuation Schedule as explained in the instructions for the schedule you are continuing. Use the Unit value column only if you are continuing Schedules B or E. For all other schedules, you may use the space under the Unit value column to continue your description.

To continue Schedule E, Part 2, you should enter the *Percentage includible* in the *Alternate valuation date* column of the Continuation Schedule.

To continue Schedule K, you should use the *Alternate valuation date* and *Alternate value* columns of the Continuation Schedule as *Amount unpaid to date* and *Amount in contest* columns, respectively.

To continue Schedules J, L, and M, you should use the *Alternate valuation date* and *Alternate value* columns of the Continuation Schedule to continue your description of the deductions. You should enter the amount of each deduction in the *amount deductible* column of the Continuation Schedule.

To continue Schedule O, you should use the space under the *Alternate valuation date* and *Alternate value* columns of the Continuation Schedule to provide the *Character of institution* information required on Schedule O. You should enter the amount of each deduction in the *amount deductible* column of the Continuation Schedule.

Carry the total from the Continuation Schedule(s) forward to the appropriate line of the main schedule.



**United States Gift (and Generation-Skipping Transfer) Tax Return**

(Section 6019 of the Internal Revenue Code) (For gifts made after October 6, 1990, and before January 1, 1993)

OMB No 1545-0020  
Expires 8-31-93

Calendar year 19 .....

▶ See separate instructions. For Privacy Act Notice, see the Instructions for Form 1040.

Part 1.—General Information

1 Donor's first name and middle initial	2 Donor's last name	3 Social security number
4 Address (number, street, and apartment number)		5 Legal residence (Domicile)
6 City, state, and ZIP code		7 Citizenship
8 If the donor died during the year, check here <input type="checkbox"/> and enter date of death....., 19 ...		
9 If you received an extension of time to file this Form 709, check here <input type="checkbox"/> and attach the Form 4668, 2688, 2350, or extension letter		
10 Enter the total number of separate donees listed on Schedule A—count each person only once <input type="checkbox"/>		
11a Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If the answer is "No," do not complete line 11b		
11b If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)?		
12 Gifts by husband or wife to third parties—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. If the answer is "No," skip lines 13-18 and go to Schedule A.)		
13 Name of consenting spouse		14 SSN
15 Were you married to one another during the entire calendar year? (See instructions.)		
16 If the answer to 15 is "No," check whether <input type="checkbox"/> married <input type="checkbox"/> divorced or <input type="checkbox"/> widowed, and give date (see instructions) ▶		
17 Will a gift tax return for this calendar year be filed by your spouse?		
18 Consent of Spouse—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.		

Consenting spouse's signature ▶

Date ▶

Part 2.—Tax Computation

1 Enter the amount from Schedule A, Part 3, line 15	1	
2 Enter the amount from Schedule B, line 3	2	
3 Total taxable gifts (add lines 1 and 2)	3	
4 Tax computed on amount on line 3 (see Table for Computing Tax in separate instructions)	4	
5 Tax computed on amount on line 2 (see Table for Computing Tax in separate instructions)	5	
6 Balance (subtract line 5 from line 4)	6	
7 Maximum unified credit (nonresident aliens, see instructions)	7	192,800 00
8 Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)	8	
9 Balance (subtract line 8 from line 7)	9	
10 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)	10	
11 Balance (subtract line 10 from line 9)	11	
12 Unified credit (enter the smaller of line 6 or line 11)	12	
13 Credit for foreign gift taxes (see instructions)	13	
14 Total credits (add lines 12 and 13)	14	
15 Balance (subtract line 14 from line 6) (do not enter less than zero)	15	
16 Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, total)	16	
17 Total tax (add lines 15 and 16)	17	
18 Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19 If line 18 is less than line 17, enter BALANCE DUE (see instructions)	19	
20 If line 18 is greater than line 17, enter AMOUNT TO BE REFUNDED	20	

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.

Donor's signature ▶

Date ▶

Preparer's signature  
(other than donor) ▶

Date ▶

Preparer's address  
(other than donor) ▶



**SCHEDULE A** Computation of Taxable Gifts

Part 1.—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions—see instructions

A Item number	B Donee's name, relationship to donor (if any), and address and description of gift. If the gift was made by means of a trust, enter trust's identifying number below and attach a copy of the trust instrument. If the gift was securities, enter the CUSIP number(s), if available.	C Donor's adjusted basis of gift	D Date of gift	E Value at date of gift
1				

**Part 2.—Gifts** Which are Direct Skips and are Subject to Both Gift Tax and Generation-Skipping Transfer Tax. You must list the gifts in chronological order. Gifts less political organization, medical, and educational exclusions—see instructions. (Also list here direct skips that are subject only to the GST tax at this time as the result of the termination of an "estate tax inclusion period." See instructions.)

A Item number	B Donee's name, relationship to donor (if any), and address and description of gift. If the gift was made by means of a trust, enter trust's identifying number below and attach a copy of the trust instrument. If the gift was securities, enter the CUSIP number(s), if available.	C Donor's adjusted basis of gift	D Date of gift	E Value at date of gift
1				

**Part 3.—Gift Tax Reconciliation**

1	Total value of gifts of donor (add column E of Parts 1 and 2)	1	
2	One-half of items ..... attributable to spouse (see instructions)	2	
3	Balance (subtract line 2 from line 1)	3	
4	Gifts of spouse to be included from Schedule A, Part 3, line 2 of spouse's return—see instructions. If any of the gifts included on this line are also subject to the generation-skipping transfer tax, check here <input type="checkbox"/> and enter those gifts also on Schedule C, Part 1.	4	
5	Total gifts (add lines 3 and 4)	5	
6	Total annual exclusions for gifts listed on 3, Schedule A (including line 4, above) (see instructions)	6	
7	Total included amount of gifts (subtract line 6 from line 5)	7	
Deductions (see instructions)			
8	Gifts of interests to spouse for which a marital deduction will be claimed, based on items ..... of Schedule A	8	
9	Exclusions attributable to gifts on line 8	9	
10	Marital deduction—subtract line 9 from line 8	10	
11	Charitable deduction, based on items to ..... less exclusions	11	
12	Total deductions—add lines 10 and 11	12	
13	Subtract line 12 from line 7	13	
14	Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)	14	
15	Taxable gifts (add lines 13 and 14). Enter here and on line 1 of the Tax Computation on page 1	15	

(If more space is needed, attach additional sheets of same size.)

**SCHEDULE A** Computation of Taxable Gifts *(continued)***16 Terminable Interest (QTIP) Marital Deduction. (See instructions.)**

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 line 8, Part 3 of Schedule A.

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 Part 1 of Schedule A is entered as a deduction on line 8, 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 line 10 of Part 3. The denominator is equal to the total value of the trust (or other property) listed in Part 1 of Schedule A.

If you make the QTIP election (see instructions for line 8 of Schedule A), the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). 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 on page 3 of the instructions).

**17 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 your answer is "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
1 Totals for prior periods (without adjustment for reduced specific exemption).		1		
2 Amount, if any, by which total specific exemption, line 1, column D, is more than \$30,000			2	
3 Total amount of taxable gifts for prior periods (add amount, column E, line 1, and amount, if any, on line 2) (Enter here and on line 2 of the Tax Computation on page 1.)			3	

(If more space is needed, attach additional sheets of same size.)

**SCHEDULE C** Computation of Generation-Skipping Transfer Tax

**Note:** *Inter vivos* direct skips which are completely excluded by the GST exemption must still be fully reported (including value and exemptions claimed) on Schedule C.

## Part 1.-Generation-Skipping Transfers

A Item No. (from Schedule A, Part 2, col. A)	B Value (from Schedule A, Part 2, col. E)	C Split Gifts (enter 1/2 of col. B) (see instructions)	D Subtract col. C from col. B	E Nontaxable portion of transfer	F Net Transfer (subtract col. E from col. D)
1					
2					
3					
4					
5					
6					
<p>If you elected gift splitting and your spouse was required to file a separate Form 709 (see the instructions for "Split Gifts"), you must enter all of the gifts shown on Schedule A, Part 2, of your spouse's Form 709 here</p> <p>In column C, enter the item number of each gift in the order it appears in column A of your spouse's Schedule A, Part 2. We have preprinted the prefix "S-" to distinguish your spouse's item numbers from your own when you complete column A of Schedule C, Part 3.</p> <p>In column D, for each gift enter the amount reported in column C, Schedule C, Part 1, of your spouse's Form 709.</p>		<p>Split gifts from spouse's Form 709 (enter item number)</p> <p>S-</p> <p>S-</p> <p>S-</p> <p>S-</p> <p>S-</p> <p>S-</p> <p>S-</p> <p>S-</p>	<p>Value Included from spouse's Form 709</p>	<p>Nontaxable portion of transfer</p>	<p>Net transfer (subtract col. E from col. D)</p>

## Part 2.—GST Exemption Reconciliation (Code section 2631) and Section 2652(a)(3) Election

Check box ☐ if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

Enter the item numbers (from Schedule A) of the gifts for which you are making this election ▶

1	Maximum allowable exemption	\$1,000,000
2	Total exemption used for periods before filing this return	
3	Exemption available for this return (subtract line 2 from line 1)	
4	Exemption claimed on this return (from Part 3, col. C total, below)	
5	Exemption allocated to transfers not shown on Part 3, below. You must attach a Notice of Allocation. (See instructions.)	
6	Add lines 4 and 5	
7	Exemption available for future transfers (subtract line 6 from line 3)	

### Part 3.-Tax Computation

A Item No. (from Schedule C, Part 1)	B Net transfer (from Schedule C, Part 1, col F)	C GST Exemption Allocated	D Divide col. C by col. B	E Inclusion Ratio (subtract col. D from 1.000)	F Maximum Estate Tax Rate	G Applicable Rate (multiply col. E by col. F)	H Generation-Skipping Transfer Tax (multiply col. B by col. G)
1					55% (.55)		
2					55% (.55)		
3					55% (.55)		
4					55% (.55)		
5					55% (.55)		
6					55% (.55)		
					55% (.55)		
					55% (.55)		
					55% (.55)		
					55% (.55)		
					55% (.55)		
Total exemption claimed. Enter here and on line 4, Part 2, above. May not exceed line 3, Part 2, above.			Total generation-skipping transfer tax. Enter here, on line 14 of Schedule A, Part 3, and on line 16 of the Tax Computation on page 1.				

(If more space is needed, attach additional sheets of same size.)

<sup>1</sup>U.S. Government Printing Office:1991—618-729/40489

Haney, Harry L., Jr.; Siegel, William 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.

This book's purpose is to provide guidelines and assistance to nonindustrial private woodland owners in applying estate planning techniques to their forest properties.

Keywords: Estate tax, estate valuation, forest estate, gift tax, timber estate.

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