

Instructions for Form 706-D, United States Additional Estate Tax Return Under Code Section 2057 (Rev. August 2006)

- Purpose:** This is the first circulated draft of the Instructions for Form 706-D, United States Additional Estate Tax Return Under Code Section 2057 (Rev. August 2006), for your review and comments. See below for a discussion of the major changes.
- TPCC Meeting:** There is no meeting scheduled but you may request one.
- Prior Version:** The Instructions for Form 706-D (Rev. October 2003) are available at: <http://www.irs.gov/pub/irs-pdf/i706d.pdf>
- Form:** The Form 706-D (Rev. August 2006) is being circulated separately.
- Other Products:** Circulations of draft tax forms, instructions, notices, and publications are posted at: http://taxforms.web.irs.gov/draft_products.html
- Comments:** Please email, fax, call, or mail any comments by **July 14, 2006**.

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Major Changes to the Instructions for Form 706-D (Rev. August 2006)

- On page 1, we added a *What's New* section with the following information:
 - Text to alert filers that all Forms 706-D must now be filed at the Cincinnati Service Center due to the rampdown of the Philadelphia Service Center. SP:HQ:Code&Edit/ERS Section.
 - Text that instructs filers to use Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes (Rev. January 2006), to apply for an automatic 6-month extension of time to file Form 706-D. Regulations section 20.6081-1.
- On page 1, under *When To File and Pay*, we updated text instructing filers to “[c]heck the ‘Form 706-D’ box” in accordance with changes previously made on Form 4768. Regulations section 20.6081-1.

- On page 1, under *Where To File*, we deleted the Philadelphia Service Center address and revised the text instructing filers to file all Forms 706-D at the Cincinnati Service Center. SP:HQ:Code&Edit/ERS Section.
- On page 4, under *Line 15, Example*, we recomputed the figures in the example to reflect 2003 maximum tax rates. SE:W:CAR:MP:T:T:R.
- On page 5, under *Privacy Act and Paperwork Reduction Act Notice*, we modified the text to more closely reflect similar text in other Form 706 series products, and updated the text in accordance with IRC section 6103(i)(3)(C). Also, in the same section, we updated the Tax Products Coordinating Committee address. SE:W:CAR:MP:T:T:SP.

Instructions for Form 706-D



Department of the Treasury
Internal Revenue Service

(Rev. August 2006)

United States Additional Estate Tax Return Under Code Section 2057

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

- Each qualified heir must file all Forms 706-D at the Cincinnati Service Center, regardless of whether the decedent was a nonresident U.S. citizen or a filer other than a nonresident U.S. citizen. See *Where To File* below for the address.
- You can apply for an automatic 6-month extension of time to file Form 706-D by filing Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes (Rev. January 2006). When asking for an automatic 6-month extension, you are not required to provide an explanation for your request. See Form 4768 for more details.

General Instructions

Purpose of Form

If an estate of a decedent dying before January 1, 2004, claimed a qualified family-owned business interest (QFOBI) deduction on Schedule T of Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, each qualified heir assumed personal liability for a portion of the reduction in estate tax resulting from the QFOBI deduction.

Section 2057 imposes an additional estate tax on a qualified heir when certain "taxable events" occur with respect to a QFOBI received by the qualified heir. The qualified heir uses Form 706-D to report and pay the additional estate tax. A qualified heir also uses Form 706-D to report certain nontaxable events.

Note. In order to properly prepare Form 706-D, you will need a copy of, or information from, the original Form 706 that the executor of the decedent's estate filed with the IRS. Generally, any heir at law, next of kin, or beneficiary under the decedent's will is entitled to inspect a return or receive return information in the case of the return of an estate if such heir, next of kin, or beneficiary has a material interest which will be affected by information

contained in the return of the estate. See section 6103(e)(1)(E)(ii).

Who Must File

Each qualified heir must file a Form 706-D to report:

- A taxable event (see *Taxable Events* below),
- An involuntary conversion or exchange of a QFOBI,
- A transfer to a family member,
- A qualified conservation contribution, or
- The loss of U.S. citizenship if the QFOBI passes or is acquired or held in a qualified trust.

When To File and Pay

File Form 706-D and pay any additional tax due within 6 months after the taxable disposition, disqualifying act, or failure to materially participate in the QFOBI, unless an extension of time has been granted.

Use Form 4768 to apply for an extension of time to file. Check the "Form 706-D" box in Part II of Form 4768.

Make the check or money order payable to the "United States Treasury" and write "Form 706-D" and the qualified heir's social security number on the check or money order.

Where To File

File all Forms 706-D at the following address:

Internal Revenue Service Center
Cincinnati, OH 45999

Statute of Limitations

The additional estate tax may be assessed until 3 years after the IRS receives notice that the qualified heir disposed of the QFOBI, material participation ended, or a disqualifying act occurred.

However, if the property was disposed of in an involuntary conversion or in an exchange, the tax may be assessed up to 3 years after the IRS receives notice that the property was replaced or will not be replaced. See section 2032A(f) for details.

Lien

If the estate elected to take the QFOBI deduction, section 6324B establishes a

special lien against the QFOBI equal to the adjusted tax difference attributable to such an interest.

Definitions

Ownership rules. *Ownership* of the business interest may either be direct, or indirect through a corporation, partnership, or a trust. An interest owned, directly or indirectly, by or for such an entity, is considered owned proportionately by or for the entity's shareholders, partners, or beneficiaries. A person is the beneficiary of a trust only if he or she has a present interest in the trust.

Qualified heir. A person is a *qualified heir* of property if he or she is a member of the decedent's family and acquired or received the QFOBI from the decedent.

If a qualified heir disposes of any QFOBI to any member of his or her family, that person will then be treated as the qualified heir with respect to that interest.

For the purpose of the QFOBI deduction, a qualified heir also includes any active employee of the trade or business to which the QFOBI relates, if the employee has been employed by the trade or business for a period of at least 10 years before the date of the decedent's death.

Member of family. The term "member of the family" includes only:

- An ancestor (parent, grandparent, etc.) of such individual;
- The spouse of such individual;
- The lineal descendent (child, stepchild, grandchild, etc.) of the individual, of the individual's spouse, or of a parent of such individual; and
- The spouse, widow, or widower of any lineal descendent described above.

A legally adopted child of an individual is treated as a child of that individual by blood.

Taxable Events

Section 2057 imposes an additional estate tax when there is a *taxable event*. A taxable event occurs if, within 10 years of the decedent's death and before the qualified heir's death, one of the following events occurs:

- The qualified heir disposes of any portion of his or her interest in the qualified family-owned business, other than by a disposition to a member of

the qualified heir's family or through a qualified conservation contribution under section 170(h);

- The qualified heir fails to meet material participation requirements because neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least 5 years of any 8-year period (see *Material Participation* on page 2);
- The principal place of business of the qualified family-owned business ceases to be located in the United States; or
- The qualified heir loses U.S. citizenship and a qualified trust was not created nor was a security arrangement made. (See page 4 for more information.)

Note. For special rules for involuntary conversions and exchanges, see the instructions for Schedule B on page 3.

The 10-year recapture period may be extended for a period of up to 2 years if the qualified heir does not begin to use the property for a period of up to 2 years after the decedent's death. (See *Two-Year Grace Period—Commencement Date* below.)

Only one additional estate tax will be imposed with respect to any one interest in the qualified family-owned business. For example, if additional estate tax is imposed for failure to materially participate in the QFOBI, a second additional estate tax will not be imposed for a subsequent early disposition of the same part of the QFOBI.

A sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (for example, the sale of crops or a tractor) would not result in recapture of the benefits of the QFOBI deduction.

Also, a distribution in redemption of stock that is part of a QFOBI and that qualifies under section 303 is not a disposition for recapture purposes.

Each qualified heir is personally liable for the portion of the recapture tax imposed with respect to his or her interest in the qualified family-owned business.

Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test.

If she fails to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the additional estate tax (that is, each

would be liable for the additional estate tax attributable to his or her interest).

Disposition to family member. If a transferee who is a family member enters into an agreement to be personally liable for any additional tax under section 2057, the disposition is nontaxable, and you should enter it on Schedule C. Otherwise, a disposition of an interest in property to a family member of the qualified heir is a taxable event, and you should enter it on Schedule A.

Material Participation

For this purpose, *material participation* is defined under section 2032A (special-use valuation) and the related regulations. See Regulations section 20.2032A-3.

Under such regulations, no one factor is determinative of the presence of material participation. The nature of the particular industry (for example, farming, manufacturing, etc.) must be considered.

Physical work and participation in management decisions are the principal factors for consideration. For example, an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement is met with respect to the qualified heir for purposes of this provision.

If a qualified heir dies before the required period has passed, any material participation requirement ends for that heir's portion of the property, provided the heir received a separate or other undivided interest from the decedent.

If qualified heirs receive successive interests in the QFOBI (for example, a life estate and remainder interests) the material participation requirement does not end for any part of the property until the later of the expiration of the recapture period or the death of the last qualified heir.

In determining whether the required participation has occurred, disregard brief periods (for example, 30 days or less) during which there was no material participation, as long as such periods were preceded and followed by substantial periods (more than 120 days) during which there was uninterrupted material participation.

Surviving spouse. A surviving spouse who received qualified real property from the predeceased spouse is considered to have materially participated if he or she was engaged in the active management of the business.

For additional details regarding material participation, see Regulations section 20.2032A-3(e).

Additional Estate Tax

The amount of the additional estate tax is equal to the applicable percentage of the adjusted tax difference attributable to the QFOBI deduction. The applicable percentage is based on the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death.

In addition, interest is due at the underpayment rate established under section 6621 for the period beginning on the date the estate tax liability was due under section 2001 and ending on the date such additional estate tax is due (section 2057(f)(2)(A)).

You may calculate this interest amount yourself, or you may have the IRS calculate it for you. If the IRS calculates the interest, there may be additional interest charged under section 6601 until the full amount is paid.

If you want the IRS to calculate the interest, you may estimate the amount of interest and pay it with the tax, following the *Note* below. This may avoid any additional interest.

Note. If you include interest with your payment, indicate the amount of interest paid on the dotted line for line 15. Do not include the interest in the entry space for line 15.

Applicable Percentage

IF the taxable event occurred in the following year of material participation. . .	THEN the applicable percentage is . . .
1 through 6 years	100%
7 years	80%
8 years	60%
9 years	40%
10 years	20%

Two-Year Grace Period—Commencement Date

No additional tax is imposed if the qualified heir begins material participation in the QFOBI within the 2-year period after the decedent's death. The date on which the qualified

heir begins material participation is the commencement date.

The 10-year recapture period is extended by the period after the decedent's death and before the commencement date.

For example, if the decedent died February 28, 2003, and the commencement date is August 1, 2004, the recapture period would begin August 1, 2004, and end July 31, 2014.

How To Complete Form 706-D

You may only file Form 706-D for one qualified heir. If a disposition, failure to materially participate, disqualifying act, involuntary conversion or exchange, or nontaxable transfer involves more than one qualified heir, each must file a separate Form 706-D.

Complete Form 706-D in this order:

1. Part I,
2. Schedules A and B,
3. Part II,
4. Schedule C.

Note. The qualified heir must sign the return.

Specific Instructions

Valuation

When computing the amounts to enter on Form 706-D, use the same values and estate tax that the executor reported on the Form 706 filed for the decedent. However, if the IRS has completed the audit of the estate tax return, use the agreed values and tax rather than the reported values and tax.

Schedule A. Disposition of Qualified Family-Owned Business Interest, Failure to Materially Participate, or Disqualifying Act

How To Complete Schedule A

On Schedule A, list every QFOBI or portion thereof that the qualified heir disposed of, or in which material participation has ended, since the date of the decedent's death and for which a Form 706-D has not been previously filed. You must also report any disqualifying act regarding the QFOBI (that is, the principal place of the qualified family-owned business is no

longer located in the United States, or the qualified heir lost United States citizenship and the QFOBI property was neither placed into a qualified trust, nor was a security arrangement made).

Do not list any interests that have already been reported on a previously filed Form 706-D. In general, do not list property interests disposed of to family members of the qualified heir. These interests should be listed on Schedule C.

Column (A). Number and list the property interests in chronological order of disposition, failure to materially participate, or disqualification.

Column (B). Use the same description in column (B) that the executor used for the QFOBI on the Form 706 filed for the decedent's estate. Include in column (B) the schedule and item number where the QFOBI was reported on the Form 706.

Column (C). Report in column (C) the date that the qualified heir disposed of the QFOBI, material participation ended, or a disqualifying act occurred.

Column (D). You only need to complete column (D) if you are reporting an involuntary conversion or exchange. If the qualified heir disposed of the QFOBI in an arm's length transaction, report the amount realized in column (D).

If the QFOBI is disposed of by the qualified heir in other than an arm's length transaction, report in column (D) the fair market value (FMV) of the QFOBI as of the date of its disposition.

If the qualified heir owned only a part of the QFOBI, report in column (D) the *pro rata* share of the amount realized or the FMV allocable to the part owned by the qualified heir.

Arm's length transaction. An *arm's length transaction* is a transaction where there is no bargain or gift element for affection or other reasons.

Amount realized. The *amount realized* is the sum of the money received plus the FMV of property (other than money) received. For the real property taxes that must be taken into account, see section 1001(b).

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

Column (E). Report in column (E) the value at the date of the decedent's death (or alternate valuation date, if applicable) of the QFOBI property that passed from the decedent to the qualified heir who disposed of the property, in which material participation has ended, or incurred a disqualifying

act. If you are reporting part of your total QFOBI, include only that *pro rata* share in column (E).

In general, use the value that the executor reported on the Form 706 filed for the decedent's estate. However, if the IRS has completed the audit of the estate tax return, use the agreed value rather than the reported value.

Schedule B. Involuntary Conversions or Exchanges

Involuntary conversions of qualified property (under the rules of section 1033) and exchanges of qualified property (under the rules of section 1031) are treated similarly when computing the additional estate tax on Form 706-D.

If you are reporting an involuntary conversion or exchange, you may not use the same Form 706-D to report any other taxable events that are not involuntary conversions or exchanges. Use a separate Form 706-D for the other taxable events.

You may report conversions and exchanges together on the same return.

Nontaxable Involuntary Conversions or Exchanges

If the qualified heir reinvests all of the involuntary conversion proceeds in qualified replacement property, or if the qualified heir exchanges qualified property solely for qualified exchange property, then there is no additional estate tax.

You should complete Form 706-D, even though there is no tax, to notify the IRS that the involuntary conversion or exchange took place. However, you need to complete only Part I, Schedule A, and Schedule B. Write "nontaxable" on line 15 of Part II.

Rules similar to those under sections 2032A(e)(14), 2032A(h), and 2032A(i) are applicable. Also, see section 2057(i).

Partially Taxable Involuntary Conversions or Exchanges

If the cost of the qualified replacement property is less than the amount realized in the involuntary conversion; or if other property, in addition to qualified exchange property, is received in the exchange, the conversion or exchange is partially taxable. You should complete all of Form 706-D and determine the tax using Part II.

List on Schedule A the QFOBI that the qualified heir disposed of, in which material participation ended, or with regard to which the disqualifying act

occurred, regardless of whether he or she received replacement or exchange property for the interest. List on Schedule B only the replacement or exchange property the qualified heir actually received.

Qualified Replacement or Exchange Property

The term “qualified replacement property” means any property which is:

- Acquired in an exchange which qualifies under section 1031, or
- The acquisition of which results in the nonrecognition of gain under section 1033.

The period of the decedent’s or family member’s ownership or material participation with respect to replaced or exchanged property is treated as the period of ownership or material participation with respect to the qualified replacement or exchange property. This applies only to that part of the FMV of the replacement or exchange property (at the date of acquisition) that does not exceed the FMV of the replaced or exchanged property (at the date of disposition).

Note. The 10-year recapture period is extended under certain circumstances. See *Two-Year Grace Period—Commencement Date* on page 2.

How To Complete Schedule B

Column (A). Make one entry for each item of qualified replacement or exchange property.

Column (B). Describe the qualified replacement property with enough detail so that the IRS can locate and value it. For more information, see the instructions to Form 706.

Column (C). For an involuntary conversion, enter the cost of the replacement property. For an exchange, enter the FMV of the replacement property.

Part II—Tax Computation

Line 1

Enter the qualified heir’s share of the QFOBIs shown on line 4 of the decedent’s Form 706, Schedule T.

Line 2

Enter the total reported value of the QFOBIs shown on line 6 of the decedent’s Form 706, Schedule T.

Line 5

Multiply the amount of gross additional estate tax entered on line 3c by the qualified heir’s percentage of QFOBIs entered on line 4 of this Form 706-D.

The result is the qualified heir’s share of the total reduction in estate tax.

Line 9

See the Applicable Percentage table on page 2.

Line 10

Multiply line 8 by the applicable percentage entered on line 9. If you completed Schedule B, complete lines 11 through 15. If you did not complete Schedule B, skip lines 11 through 14 and enter the amount from line 10 on line 15.

Line 15

Enter the additional estate tax due.

Show, on the dotted line for line 15, interest at the underpayment rate established under section 6621 for the period beginning on the date the estate tax liability was due and ending on the date such additional estate tax is due.

Example. April Green died November 1, 2003. On the Form 706 filed for her estate, the executor elected to claim the maximum QFOBI deduction of \$675,000 based on her ownership of 100% of the stock in XYZ Corp. The estate tax value of the stock was \$900,000. June Green, April Green’s daughter and sole heir, received all of the XYZ stock from the estate, and managed the corporation. On June 30, 2005, June Green sold part of the stock to a person other than a qualified heir. The stock sold had an estate tax value of \$200,000.

The following amounts should be entered on the Form 706-D filed by June Green to report the sale of stock:

Line 1. \$900,000 (the qualified heir’s share of the total QFOBIs as shown on line 4 of the Schedule T, Form 706).

Line 2. \$900,000 (the total reported value of all the decedent’s QFOBIs shown on line 6 of the decedent’s Schedule T, Form 706).

Line 3c. \$330,750 (gross additional estate tax).

Line 4. 100%

Line 5. \$330,750 (qualified heir’s share of total reduction in estate tax).

Line 6. \$200,000 from column (E), Schedule A of this Form 706-D (estate tax value of the QFOBI disposed of).

Line 7. 22.2%

Line 8. \$73,427

Line 9. 100% as the applicable percentage (the recapture event occurred within 4 years of the decedent’s death).

Line 10. \$73,427, total additional estate tax.

Line 15. \$73,427, additional estate tax due (there were no entries on lines 11 through 14).

Interest was not entered on the dotted line of line 15. June Green, the qualified heir, chose to have the Internal Revenue Service compute the interest on the additional estate tax due.

Schedule C. Nontaxable Transfers

Disposition to family member. You may enter a disposition to a family member of the qualified heir on Schedule C only if you file this Form 706-D on time (including extensions) and attach an agreement by the transferee to be personally liable for any additional estate tax under section 2057(f) on the QFOBI received. For a format for such an agreement, see Form 706, Schedule T (section 2057(h)).

If you are not filing this Form 706-D on time, or if the transferee does not enter into the agreement, you must enter the disposition(s) on Schedule A instead of Schedule C.

Qualified conservation contribution.

Enter a disposition made through a qualified conservation contribution under section 170(h). In general, the term “qualified conservation contribution” means a contribution:

- Of a qualified real property interest,
- To a qualified organization,
- Exclusively for conservation purposes.

Attach a copy of the Form 8283, Noncash Charitable Contributions, that was filed.

Also, as stated in the Instructions for Form 8283, attach a statement that:

- Identifies the conservation purposes furthered by your donation,
- Shows, if before and after valuation is used, the FMV of the underlying property before and after the gift,
- States whether you made the donation in order to get a permit or other approval from a local or other governing authority and whether the donation was required by a contract, and
- Describes whether you or a related person has any interest in other property nearby.

For more information, see Pub. 561, Determining the Value of Donated Property, and section 170(h) and the related regulations.

Loss of U.S. citizenship. A qualified heir who loses U.S. citizenship (and, in some circumstances, a long-term resident who ceases to be treated as such) may avoid additional estate tax by placing the qualified family-owned business assets into a trust meeting certain requirements, or by furnishing a

bond in lieu of personal liability. See section 2057(g) for details.

Show in Schedule C if the qualified heir lost U.S. citizenship (or long-term residency), and such heir complied with the requirements of section 2057(g). Attach a copy of the qualified trust agreement or evidence of the bond. See section 2057(f)(1)(C) for more information.

How To Complete Schedule C

See the instructions for completing columns (A) and (B) of Schedule A, beginning on page 3. Report the applicable dates in column (C).

Privacy Act and Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. Section 6109 requires that you provide your social security number; this is so we know who you are, and can process your Form 706-D. We need the information to figure and collect the right amount of tax. Subtitle B, Estate and Gift Taxes, of the Internal Revenue Code, imposes a tax in some cases on

qualified heirs when a section 2057(f) "taxable event" occurs with respect to a QFOBI. Form 706-D is used to determine the amount, if any, of taxes owed.

Generally, tax returns and return information are confidential, as stated in section 6103. However, section 6103 allows or requires the Internal Revenue Service to disclose or give such information shown on your Form 706-D to the Department of Justice to enforce the tax laws, both civil and criminal, and to cities, states, the District of Columbia, U.S. commonwealths or possessions, and certain foreign governments for use in administering their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records

relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	39 min.
Learning about the law or the form	45 min.
Preparing the form	56 min.
Copying, assembling, and sending the form to the IRS	34 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the tax form to this office. Instead, see *Where To File* on page 1.