

Disclosing Gifts on Gift Tax Returns

Abstract:

Taxpayers will want to file gift tax returns to report all gifts made, even if they are under the required filing limit. A section of the Taxpayer Relief Act of 1997 provides that when a gift tax return is filed, the IRS may not challenge the value of the gift if the statute of limitations has run. This material discusses the law, lists the disclosure rules and gives examples on how to file the appropriate tax returns.

DISCLOSING GIFTS ON GIFT TAX RETURNS

The Taxpayer Relief Act of 1997 (TRA of 1997) dramatically changed the effect of filing gift tax returns.

Prior Law. Prior to the TRA of 1997, there was no statute of limitations on the valuation of gifts for purposes of the estate tax calculation. Consequently, upon death of the donor, the IRS could challenge the reported or unreported value of a gift for purposes of including prior gifts in the estate tax calculation.

Example 37. Marshall Law gave 10,000 shares of stock in his closely held company to his daughter, Anne, in 1990. He reported a value of \$110,000 for the stock on a timely filed gift tax return for 1990. The annual exclusion reduced the taxable gift to \$100,000, and the unified credit available in 1990 offset the tentative tax on the transfer, so there was no gift tax due. Marshall made no other taxable gifts during his life.

Marshall passed away in 2000. His will left his entire \$700,000 taxable estate to his daughter, Anne. As personal representative of his estate, Anne filed the following Form 706 showing \$29,250 of estate taxes due.

On audit of Marshall's estate tax return, the IRS determined that the value of the stock given to Anne in 1990 was \$310,000, rather than \$110,000. Therefore, the IRS increased the estate tax due by \$78,000 as follows:

		Originally Reported	Adjustment	Adjusted Amount
1.	Total gross estate less exclusion	\$760,000	-0-	\$760,000
2.	Total allowable deductions	<u>60,000</u>	-0-	60,000
3.	Taxable estate	\$700,000	-0-	\$700,000
4.	Adjusted taxable gifts	<u>100,000</u>	\$200,000	300,000
5.	Add lines 3 and 4	\$800,000	\$200,000	\$1,000,000 0
6.	Tentative tax	\$267,800	\$78,000	\$345,800
9.	Total gift tax payable	<u>-0-</u>	-0-	<u>-0-</u>
10.	Gross estate tax	\$267,800	\$78,000	\$345,800
13.	Allowable unified credit	<u>220,550</u>	-0-	<u>220,550</u>
14.	Subtract line 13 from line 10	\$47,250	\$78,000	\$125,250
15.	Credit for state death taxes	<u>18,000</u>	-0-	<u>18,000</u>

16.	Subtract line 15 from line 14	\$29,250	\$78,000	\$107,250
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TRA of 1997. The TRA of 1997 gives taxpayers a statute of limitations for purpose of the estate tax if the statute has run for purposes of the gift tax.

Example 38. Hy Towers gives closely held stock to his daughter, Belle, in 2000, and adequately discloses it as a \$100,000 gift on a timely filed gift tax return. The IRS does not challenge the \$100,000 valuation. Hy dies in 2010, leaving his \$700,000 estate to Belle. The IRS cannot challenge the \$100,000 valuation of the stock on Hy's estate tax return.

TRA OF 1997 DISCLOSURE RULES

While the TRA of 1997 disclosure rules were enacted to put a statute of limitations on the valuation of gifts for estate tax purposes, they also have an effect on the gift tax statute of limitations in two respects. First, they increase the reporting requirements for starting the running of the statute of limitations. Second, they apply the statute of limitations not only to the valuation of the gift, but also to the application of the gift tax rules to the gift tax computation. In other words, they impose a **higher burden** for starting the statute of limitations but give the taxpayer **greater protection** if the statute has run.

There are two separate but related gift tax calculations that are affected by the new disclosure rules. One is calculation of gift taxes due in the year of the gift. A second is the calculation of gift taxes in a later year, when the gift is included as a prior-year gift.

Gift taxes in the year of the gift. Under prior law, the three-year statute of limitations began to run in the gift tax liability of a taxpayer if the taxpayer filed a gift tax return for the year of the gift. Therefore, if a taxpayer filed a gift tax return but omitted a gift from the return, the IRS could not assess a gift tax on the omitted gift after the period ending three years after the gift tax return was filed.

<p>Practitioner Note. Under prior law, if unreported gifts exceeded 25% of the gifts reported on the gift tax return, the statute of limitations was six years rather than three years.</p>
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Example 39. In 1994, Hugh Midd gave \$400,000 of publicly traded stock to his daughter. He also sold 10% of his business to his son for \$100,000. Hugh filed a gift tax return before April 15, 1995, and reported the \$400,000 gift to his daughter. There was no gift tax due as a result of the unified credit that was available in 1994. He did not report the sale of the 10% interest in his business because he believed the value of the interest was \$100,000 and there was no gift.

After April 15, 1998 (three years after the due date of the 1994 gift tax return), the IRS cannot impose additional gift taxes on Hugh even if the IRS can prove the value of the 10% interest in his business is more than \$200,000, since the unreported gift (\$200,000 \$100,000 \$100,000) is not more than 25% of the \$400,000 reported gifts. After April 15, 2001 (six years after the due date of the 1994 gift tax return), the IRS cannot impose additional gift taxes on Hugh regardless of the value it can prove for the 10% interest in his business.

Practitioner Note. Under prior law, a gift tax return that was not required to be filed apparently did not start the statute of limitations. For example, if a donor's only gift was a gift of \$9,000, reporting it on a gift tax return did not start the statute of limitations because such gifts did not trigger the filing requirement. Under the TRA of 1997 rules, filing a gift tax return even when it is not required will start the statute if the adequate disclosure requirements are met.

Under the TRA of 1997, the statute of limitations does not run for a gift unless that gift is adequately disclosed on a gift tax return or otherwise meets the disclosure requirements.

Example 40. Assume the same facts as in Example 39, except that Hugh made his gift to his daughter and sold the 10% interest in his business to his son in 2000. If Hugh does not adequately disclose the transfer of the interest in his business to his son on a gift tax return, the IRS can assess gift taxes for that transfer at any time.

A transfer to a family member in the ordinary course of business is adequately disclosed if both parties report the transaction on a their income tax returns. It does not have to be reported on a gift tax return.

Example 41. If Hugh paid his son a salary for working in the business, the statute of limitations begins to run for gift tax purposes on that transfer if Hugh shows the salary as a deduction on his income tax return and his son reports it as income on his return.

Practitioner Note. Reporting a **transfer of an interest in a business** on an income tax return is not adequate disclosure, since that transfer is not in the ordinary course of business.

Gift taxes for year after the gift. A gift affects the calculation of gift taxes in a subsequent year because all prior taxable gifts are a part of the gift tax calculation. However, under prior law, a different rule applied for starting the statute of limitations with respect to valuing the gift for the subsequent year calculation. The IRS could revalue a prior gift unless a gift tax was paid or assessed for the year of the gift, **and** the time had expired for assessing a gift tax for the year of the gift.

Example 42. Assume the same facts as in Example 39 (gift to daughter and sale to son in 1994) and in addition, assume that Hugh gave \$400,000 of publicly traded stock to his son in 2000. Since Hugh did not owe any gift tax for his 1994 gift to his daughter, the IRS can revalue his gift to his daughter and revalue the transfer of the 10% interest in his business to his son at any time for purposes of including the gifts in a subsequent year gift tax calculation. Assuming the IRS can prove the value of the 10% interest in the business was \$200,000, the gift taxes for 2000 before and after the revaluation of the 1994 transfer are shown below.

	Before Revaluation	After Revaluation
Taxable gift in 2000	\$390,000	\$390,000
Prior taxable gifts	<u>390,000</u>	<u>480,000</u>
Total taxable gifts	\$780,000	\$870,000
Tentative tax	\$260,000	\$295,100
Less applicable credit amount	<u>220,550</u>	<u>220,550</u>
Gift taxes due	\$ 39,450	\$ 74,550

Under the TRA of 1997 rules, if the statute of limitation has run for purposes of the gift tax liability in the year of the gift, it has also run for purposes of the gift tax liability in a subsequent year.

Example 43. Assume the same facts as in Example 40 (gift to daughter and sale to son in 2000) and in addition, assume that Hugh gave \$400,000 of publicly traded stock to his son in 2006. If Hugh adequately discloses the transfer of the 10% interest in his business on his 2000 gift tax return, the statute of limitations on challenging the value of that transfer runs for purposes of gift taxes for later years as well as for gift taxes in 2000. Therefore, the IRS could not challenge the value of the 2000 transfer as a prior gift in the 2006 gift tax calculation.

Omitted Gifts. If a gift is inadvertently omitted from a previously filed gift tax return, an amended gift tax return for the year in which the gift was made must be filed with the same Service Center where the prior gift tax return was filed. On the top of the first page of the amended return, write the words "Amended Form 709 for gift(s) made in (calendar year that the gift was made)." The return must identify the transfer and provide all information required under the disclosure rules. If this procedure is followed, the statute of limitations will begin running on the omitted gift.

DISCLOSURE REQUIREMENTS

A transfer is adequately disclosed on a gift tax return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value that is reported. Transfers reported on the gift tax return as transfers of property by gift are adequately disclosed if the return (or a statement attached to the return) provides the following information:

1. A description of the transferred property and any consideration received by the transferor
 - For real estate, provide:
 - a. A legal description of each parcel
 - b. The street number, name and area if the property is located in a city
 - c. A short description of any improvements to the property
 - For bonds, give:
 - a. The number of bonds transferred
 - b. The principal amount of each bond
 - c. Name of obligor
 - d. Date of maturity

- e. Rate of interest
 - f. Date or dates when interest is payable
 - g. Series number if there is more than one issue
 - h. Exchanges where listed or, if unlisted, give the location of the principal business office of the corporation
 - i. CUSIP number
- For stocks:
 - b. Give number of shares
 - c. State whether common or preferred
 - d. If preferred, give the issue, par value, and exact name of corporation
 - e. If listed on a principal exchange, give location of principal business office of corporation, state in which incorporated, and date of incorporation
 - f. If listed, give principal exchange
 - g. CUSIP number
 - For interests in property based on the length of a person's life:
 - a. Give the person's date of birth
 - For life insurance policies:
 - a. Give the name of the insurer and the policy number
 - b. The identity of, and relationship between, the donor and each donee
 - c. If the property is transferred in trust:
 - b. The trust's tax identification number and a brief description of the terms of the trust, (or in lieu of a brief description of the trust terms) A copy of the trust instrument
 - d. Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift:
 - a. Including any financial data (for example, balance sheets, with explanations of any adjustments) that were utilized in determining the value of the interest

- b. Any restrictions on the transferred property that were considered in determining the fair market value of the property
 - c. A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property
- e. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis:
- e. Including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements
6. In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded:
- a. A description of any discount claimed in valuing the interests in the entity or any assets owned by such entity must be provided
 - b. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity)
 - c. The pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return
 - d. If 100% of the value of the entity is not disclosed, the tax payer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity
 - e. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required must be provided for each entity, if the information is relevant and material in determining the value of the interest
7. A statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer (see Treas. Reg. §601.601(d)(2) of this chapter).
8. Statement of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued. The appraisal is prepared by an appraiser who satisfies all of the following requirements:

- a. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis
 - b. The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee
 - c. The appraiser is not any person employed by the donor, the donee, or a member of the family of either
9. The appraisal contains all of the following:
- a. The date of the transfer
 - b. The date on which the transferred property was appraised, and the purpose of the appraisal
 - c. A description of the property
 - d. A description of the appraisal process employed
 - e. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions
 - f. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value
 - g. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions
 - h. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred
 - i. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc. The following examples illustrate the disclosure rules:

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Example 44: Transfer of stock adequately disclosed. In 2001, Ace transfers 100 shares of common stock of XYZ Corporation to Ace's child. The common stock of XYZ Corporation is actively traded on a major stock exchange. For gift tax purposes, the fair market value of one share of XYZ common stock on the date of the transfer is \$150.00. Ace reports the gift to Ace's child of 100 shares of common stock of XYZ Corporation with a value for gift tax purposes of \$15,000. Ace specifies the date of the transfer, recites that the stock is publicly traded, identifies the stock exchange on which the stock is traded, lists the stock's CUSIP number, and lists the mean between the highest and

lowest quoted selling prices for the date of transfer. Ace has adequately disclosed the transfer.

Example 45: Transfer of closely held stock adequately disclosed. Ace owns 100% of the common stock of X, a closely held corporation. X does not hold an interest in any other entity that is not actively traded. In 2001, Ace transfers 20% of the X stock to Barb and Carl, Ace's children. The transfer is made outright with no restrictions on ownership rights, including voting rights and the right to transfer the stock. Based on generally applicable valuation principles, the value of X would be determined based on the net value of the assets owned by X. The reported value of the transferred stock incorporates the use of minority discounts and lack of marketability discounts. No other discounts were used in arriving at the fair market value of the transferred stock or any assets owned by X. Ace provides the information required—a statement reporting the fair market value of 100% of X (before taking into account any discounts), the pro rata portion of X subject to the transfer, and the reported value of the transfer. Ace also attaches a statement regarding the determination of value, that includes a discussion of the discounts claimed and how the discounts were determined. Ace has provided sufficient information such that the transfer will be considered adequately disclosed, and the period of assessment for the transfer will run from the time the return is filed.

Example 46: Transfer of interest LLP not adequately disclosed. Ace owns a 70% limited partnership interest in PS. PS owns 40% of the stock in X, a closely held corporation. The assets of X include a 50% general partnership interest in PB. PB owns an interest in commercial real property. None of the entities (PS, X, or PB) is actively traded and, based on generally applicable valuation principles, the value of each entity would be determined based on the net value of the assets owned by each entity. In 2001, Ace transfers a 25% limited partnership interest in PS to Barb, Ace's child. On the federal gift tax return, Ace reports the transfer of the 25% limited partnership interest in PS and that the fair market value of 100 percent of PS is \$y and that the value of 25% of PS is \$z, reflecting marketability and minority discounts with respect to the 25% interest. However, Ace does not disclose that PS owns 40% of X, and that X owns 50% of PB and that, in arriving at the \$y fair market value of 100% of PS, discounts were claimed in valuing PS's interest in X, X's interest in PB, and PB's interest in the commercial real property.

The information on the lower-tiered entities is relevant and material in determining the value of the transferred interest in PS. Accordingly, because Ace has failed to comply with disclosure requirements regarding PS's interest in X, X's interest in PB, and PB's interest in the commercial real property, the transfer will not be considered adequately disclosed, and the period of assessment for the transfer will remain open indefinitely.

Example 47: Transfer of interest in LLP adequately disclosed. The facts are the same as in Example 46 except that Ace submits, with the federal tax return, an appraisal of the 25% limited partnership interest in PS that satisfies the disclosure requirements. Assuming the other disclosure requirements are satisfied, the transfer is considered adequately disclosed and the period for assessment for the transfer will run from the time the return is filed.

Example 48: Transfer of property to related parties adequately disclosed. Ace owns 100% of the stock of X Corporation, a company actively engaged in a manufacturing business. Barb, Ace's child, is an employee of X and receives an annual

salary paid in the ordinary course of operating X Corporation. Barb reports the annual salary as income on her income tax returns. In 2001, Ace transfers property to family members and files a Federal gift tax return reporting the transfers. However, Ace does not disclose the 2001 salary payments made to Barb. Because the salary payments were reported as income on Barb's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to Barb, reported on the gift tax return must satisfy the adequate disclosure in order for the period of assessment to commence to run with respect to those transfers.

EFFECTIVE DATES

The new rules have effective dates for purposes of calculating current gift taxes on the gift that differ from those for purposes of calculating gift taxes for subsequent years and estate taxes.

Current year gift taxes. For purposes of calculating current gift taxes, the new rules are effective for gifts made after December 31, 1996, for which a gift tax return is filed after December 3, 1999.

Gift taxes for subsequent years and estate taxes. For purposes of calculating gift taxes in a year after the gift and for purposes of calculating estate taxes upon death of the donor, the new rules are effective for gifts made after August 5, 1997, if the gift tax return for year of the gift is filed after December 3, 1999.

The new regulations under I.R.C. §2504 give the following example [Treas. Reg. §25.2504-2(c) Example 3].

Example 49. In 1994, A transferred closely held stock to B and C, A's children. A timely filed a Federal gift tax return reporting the 1994 transfers to B and C, and paid gift tax on the value of the gifts reported on the return. Also in 1994, A transferred closely held stock to B in exchange for a bona fide promissory note signed by B. A believed that the transfer to B in exchange for the promissory note was for full and adequate consideration and A did not report that transfer to B on the 1994 Federal gift tax return. In 2002, A transfers additional property to B and timely files a federal gift tax return reporting the gift.

Under I.R.C. §2504(c), in determining A's 2002 gift tax liability, the value of A's 1994 gifts cannot be adjusted for purposes of computing prior taxable gifts because those gifts were made prior to August 6, 1997, and a timely filed federal gift tax return was filed with respect to which a gift tax was assessed and paid, and the period of limitations on assessment has expired. The provisions of paragraph (a) of this section apply to the 1994 transfers. However, for purposes of determining A's adjusted taxable gifts in computing A's estate tax liability, the gifts may be adjusted [See Treas. Reg. §20.2001-1(a)].

FILING DEADLINE

Gift tax returns are due by April 15 of the year following the calendar year in which the gift was made. If the donor has been given an extension to file his or her income tax

return for the calendar year of the gift, the date for filing the gift tax return is extended to the same date. There is no penalty for filing a gift tax return late if there is no gift tax due other than the delay in starting the statute of limitations.

Example 50. Malcolm Tente gave 1,000 units of his Limited Liability Company (LLC) to his daughter in 1997. Malcolm valued the 1,000 units at \$200,000. As a tax protester, he has not filed income or gift tax returns for several years. Malcolm went to see a tax preparer in 2000 and asked about the consequences of filing a gift tax return for the 1997 gift.

One effect of filing a gift tax return in 2000 for the 1997 gift is that it will start the 3-year statute of limitations running as of the date of filing the return. If the return had been filed by the April 15, 1998, due date, the statute would have expired on April 15, 2001.

<p>Observation. Many gifts trigger the gift tax return filing requirement without triggering any gift tax liability because the applicable credit amount (\$220,550 in 2000) offsets the gift tax liability</p>
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There is a penalty for a late payment of gift taxes. If the gift tax return is filed late, there is a penalty based on the gift taxes due on the return reduced by any gift taxes that were paid on time.

The penalty for a late payment of gift tax is the same as the penalty for late payment of income taxes. It is 0.5% of the taxes due for each month or portion of a month the taxes are paid late, up to a maximum of 25%.

The penalty for filing a gift tax return late is the same as the penalty for filing an income tax return late. It is 5% of the taxes due for each month or portion of a month the return is filed late, up to a maximum of 25%.

Example 51. Sally Forth gave \$700,000 of stocks and bonds to her two children in 1999. She asked her income tax preparer to get an extension for filing her income tax return for 1999. Sally did not tell her preparer about the gifts until she took her records to him in June 2000. Her preparer filed a Form 709 on June 20, 2000, showing the \$700,000 gift and a \$1,850 gift tax due. There is no penalty for the late-filed gift tax return because the due date of Sally's income tax return was extended to August 15, 2000. There is a penalty for the late payment of gift taxes. It is 3 months 0.5% \$1,850 \$27.75. Sally must also pay interest on the late payment of gift taxes.