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Specialty Law Columns Estate and Trust Forum

The Perilous Federal Gift Tax Return--Part I
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Editor's Note:

This is the first part of a two-part article regarding the federal gift tax return. Part I of the article reviews basic reporting rules, and then focuses on the gift tax statute of limitations and the new proposed regulations on adequate disclosure of gifts. Part II, to be published in the December issue, will concern allocation of the Generation Skipping Transfer ("GST") exemption on the federal gift tax return.

Virtually every substantial estate plan involving lifetime transfers will require the filing of a Form 709—United States Gift (and Generation-Skipping Transfer) Tax Return ("GTR") at one time or another. Often, the GTR becomes an annual requirement in a plan involving an ongoing gifting program. This is especially true in plans involving valuation discounts.

The GTR has become so pervasive that even if the taxpayer is not required to file a GTR for a given transfer, an intimate knowledge of the GTR and its requirements is necessary to determine that the taxpayer fits within a filing exception. Gifts that may be excluded from the federal gift tax and its reporting requirements may still require the filing of a GTR to allocate generation-skipping transfer ("GST") exemption, or just to begin the statute of limitations ("SOL") period running.

Gift Taxes and the Form 709

Federal gift and estate taxes operate as a unified system. Taxable gifts reported on a GTR use a portion of the applicable credit amount allowed to each taxpayer against life and death transfers. The applicable credit amount reduces a taxpayer's gift and estate taxes by the amount of tax that would apply to what is referred to as the applicable exclusion amount. The applicable exclusion amount is scheduled to increase from the current \$650,000 to \$1 million by 2006.¹ Gift tax returns reflect the cumulative value of all taxable gifts made to the date of filing. Once the applicable credit amount has been used, gift tax must be paid on additional taxable gifts. In order to prepare a GTR, the return preparer should have all prior GTRs that have been filed by the taxpayer.

Gifts required to be reported must be reported on either Form 709 or 709-A (when filing solely to elect gift-splitting between spouses of not more than \$20,000 per donee). The Form 709 is now being revised annually to account for the annual change in the applicable credit amount. The year of the revision will appear on the form. A married couple may not file a joint gift tax return. However, spouses may elect to split gifts, made by either, to be considered as being made one-half by each. Gift splitting elections are effective for gifts and the generation-skipping transfer tax ("GSTT").²

The instructions to Form 709 are designed to explain the relevant requirements of the Internal Revenue Code ("IRC") and Treasury Regulations ("Treas. Reg."), but do not bind the IRS.³ It is "well-established principle that the authoritative sources of Federal tax law are statutes, regulations, and judicial decisions,

and not informal publications." Practitioners "cannot rely on informal IRS instructions to justify a reporting position that is otherwise inconsistent with the controlling statutory provisions."⁴ Therefore, taxpayers who rely solely on IRS forms and instructions are at risk.⁵ However, in some cases, direction is given in IRS instructions that is more complete than any other source.⁶ Therefore, while not determinative of the law, close reading and strict compliance are recommended.

What is Reportable

The definition of a gift for federal reporting purposes is extremely broad and beyond the scope of this article.⁷ Page 1 of the instructions provides an overview of "Transfers Subject to the Gift Tax" and "Transfers Not Subject to the Gift Tax." Generally, with the very limited exceptions of gifts to political organizations, transfers not fully excluded under the annual exclusion of IRC § 2503(b) and (c), and under the educational and medical exclusions of IRC § 2503(e), every gratuitous transfer is reportable. Reportable transfers would include transfers for less than adequate consideration, forgiveness of debt, interest-free or below market interest rate loans, and the exercise or release of a general power of appointment.⁸

For gifts made in 1998 and thereafter, if the only gifts made for the year were deductible gifts to qualified charities, filing is no longer required, as long as the entire interest in the property is transferred. A GTR must be filed if only a partial interest is transferred to a charity, or part of the interest is transferred to someone other than a charity.

A GTR need not be filed to report a gift to a spouse, regardless of amount, unless one of the following exceptions applies: (1) the spouse is not a U.S. citizen and the total annual gifts to the spouse exceed \$100,000; or (2) the gift is of a terminable interest but does not meet the IRC requirements of a life estate with power of appointment.⁹ A GTR must be filed to make a QTIP (Qualified Terminable Interest Property) election for a lifetime gift. If the gift meets the requirements of IRC § 2523(f), the QTIP election is made by listing the property on Schedule A and deducting its value on line 8, Part 3, Schedule A. The QTIP election may not be made on a late-filed GTR.

Examples of common estate planning devices requiring consideration of the GTR filing requirements are as follows: (1) outright present-interest gifts made in calendar years ending after August 5, 1997 (even those not exceeding the annual exclusion), which must now be "adequately disclosed" on a GTR to trigger the new SOL on revaluation, and assessment and collection of gift tax; (2) transfers to irrevocable life insurance trusts ("ILITs") or other irrevocable trusts; (3) transfers, outright or in trust, of interests in limited liability entities such as family limited partnerships ("FLPs") and family limited liability companies ("FLLCs"); (4) transfers to grantor retained annuity trusts ("GRATs") and qualified personal residence trusts ("QPRTs") constitute gifts of future interests that require the filing of a GTR; (5) transfers to grandchildren, or more remote descendants, outright or in trust, or other individuals relegated to the category of "skip-persons"¹⁰ by Chapter 13 of the IRC. While the deemed allocation rules applicable under the GST regulations may automatically allocate sufficient GST exemption to result in an inclusion ratio of zero, filing of a GTR is recommended for record-keeping purposes. The GST allocation rules are discussed in Part II of this article.

Description of Property Listed on Return

All reported transfers, even if made solely for GST exemption allocation purposes, must be reported on Part 1 or 2 of Schedule A and described in a manner such that they may be readily identified.¹¹ Close attention must be paid to the specific requirements set forth in the Instructions for Part 1 of Schedule A and in the regulations.¹² Often, a good deal of preparer time is expended in providing the requested detail. A particularly onerous and time-consuming requirement is that the donor's adjusted basis of the reported gift must be shown, even though it does not affect the gift-tax calculation. This entry is required under column C of both parts of Schedule A and should never be ignored, as the GTR will be returned by the IRS if omitted.

A question on Line A of Schedule A now states: "Does the value of any item listed on Schedule A reflect any valuation discount?" If the answer is yes, the instructions direct that if the value of any gift reported in either part of Schedule A reflects a discount for lack of marketability, a minority interest, a fractional interest in real estate, blockage, market absorption, or any other reason, the taxpayer must attach an explanation giving the factual basis for the claimed discounts and the amount of the discounts taken.¹³ Adequate appraisals and business valuations explaining the basis of the discount should suffice. However, the new proposed regulations regarding adequate disclosure of gifts, discussed below, will add to the burden of this requirement if it is desired to begin the running of the statute of limitations on the reported gift.

Additional supplemental documentation required to support valuation includes real estate appraisals, valuations of closely held businesses (including balance sheets, statements of net earnings or operating results, and dividends paid for each of the five preceding years), and Forms 712 for life insurance policies. Certified or verified copies of trust instruments to which reported gifts were made must be attached to the return on which the first transfer to the trust was made. The trust instrument need not be attached to returns reporting subsequent transfers unless the trust provisions have been revised.¹⁴ It is probably sufficient to note on subsequent returns that a copy of the trust instrument was attached to the Form 709 filed for _____ (state the year).

When to File

The GTR is an annual return. Generally, the return for gifts in the preceding year must be filed after January 1 but not later than April 15. If the donor of the gifts dies during the year in which the gifts were made, the executor (personal representative) must file the donor's form 709 not later than the earlier of (1) the due date (with extensions) for filing the donor's estate tax return, or (2) April 15 of the year following the calendar year when the gifts were made. Thus, the GTR may be due before April 15 if the donor dies before July 15 of the year in which the gifts were made. If the donor dies after July 14, the due date for the GTR (without extensions) will always be April 15 of the following year. If no estate tax return is required, the due date for the GTR (without extensions) will be April 15.¹⁵

The executor for a deceased spouse or the guardian for a legally incompetent spouse may sign the consent to split gifts.¹⁶ The donor's agent may not sign a GTR for the donor, unless the donor is unable to sign due to illness, absence, or nonresidence. Mere convenience is not a sufficient reason for authorizing an agent to make a return.¹⁷ If a return is signed by an agent, a statement fully explaining the inability of the donor must accompany the return. Returns made by agents must be ratified by the donor or other person liable for its filing within a reasonable time after the donor becomes able to do so. If not so ratified, it will not be considered filed. However, if an agent files a return on behalf of an incapacitated donor, ratification may not be required if the donor does not regain capacity.¹⁸

Late allocations of GST exemption may be made on a Form 709. However, this does not relieve a taxpayer of the filing requirements for the gift for which a late allocation may subsequently be made. GST exemption allocation requirements will be discussed in Part II of this article.

The simplest way to obtain extensions of time to file the GTR is by checking the box for an automatic extension for the Form 709 on a request for extension of time to file the taxpayer's federal income tax return. Income tax extensions are made by using Forms 4868, 2688, or 2350, which all have check boxes for Form 709. It is assumed, though not clearly stated on the form, that the automatic extension for Form 709 allowed with Form 4868 is for an additional four months, like the income tax. If the taxpayer is not requesting an extension of time to file the income tax return, an extension of time to file the GTR must be by letter to the district director or service center for the taxpayer's area explaining the reasons for the delay.

IRC § 6081 provides that a reasonable extension of time may be granted, but generally not to exceed six months. Of course, an extension of time to file does not relieve a taxpayer of the obligation to pay any

estimated gift or GST tax due. Extensions of time to pay gift or GST taxes must be requested separately.¹⁹

Failure to Report

Absent a showing of reasonable cause for delay, if a GTR is required to be filed and is not filed by the due date, a penalty is imposed of up to 25 percent of the amount of the gift tax required to be reported, depending on the length of the delay in filing. If gift tax is not paid when due, there is a penalty of up to 25 percent of the gift tax due, depending on the length of delay, which is in addition to any penalty for a failure to file the GTR by the due date. Additional penalties may apply if a notice of demand is issued.²⁰

Because all of these penalties are a percentage of the tax required to be paid, there is effectively no penalty for a late filing of the GTR if no tax is due. However, a willful failure to file a GTR or pay gift tax as required by the IRC is a misdemeanor.²¹ Failure to file a timely return also may have a significant effect on a GST exemption allocation. (Automatic and late allocation of GST exemption is discussed in Part II.) Remember, a QTIP election may not be made on a late-filed Form 709.

Statute of Limitations and Adequate Disclosure

Legislative changes made by Congress in 1997 and 1998 purported to offer greater certainty in the area of gift tax assessment and valuation. The new law provides that if any gift made in a calendar year ending after August 5, 1997, is "adequately disclosed" in a GTR, or in the appropriate statement attached to the GTR, gift tax may not be assessed,²² nor may it be revalued in determining gift or estate tax liability²³ after the expiration of the SOL on assessment.

For items properly disclosed, the SOL ends three years after the date of filing, whether the return is timely or late.²⁴ However, any return filed before the last day prescribed for a timely filing of such return shall be considered as filed on such last day.²⁵ For example, if a timely GTR is filed by a living donor in March 1999 for a gift made during calendar year 1998, the SOL would end on April 15, 2002, three years after the due date of April 15, 1999.

In the case of a false or fraudulent return, a willful attempt to defeat or evade tax or the failure to file a return, no gift tax SOL will apply.²⁶ If a GTR omits items having a value greater than 25 percent of the total amount of gifts stated in the return, the SOL is increased to six years from the date the return is filed. This "substantial omission" rule also now provides that an item will not be considered omitted if adequate disclosure is made on the return or in a statement attached to the return.²⁷

Prior to the recent statutory changes, IRC § 6501 provided that the SOL on assessment of gift tax for a calendar period generally ended after three years. The SOL applied to all gifts made in a reporting period, whether reported or not. Under the new rules, the SOL for reported items will not run unless the item is adequately disclosed to the IRS. Thus, innocently omitted gifts may now be pursued long after the fact, unlike an innocent omission of income from an income tax return.

Adequate disclosure requires that any item for which it is desired that the SOL run be disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.²⁸ Proposed regulations issued on December 22, 1998, are intended to clarify the meaning of "adequate disclosure."²⁹ The proposed regulations set forth broad and potentially burdensome filing requirements for transfers reported as gifts, as well as for "non-gift" or "incomplete" transfers.³⁰ The proposed rules would apply to gifts made in calendar years ending after August 5, 1997, if the GTR for such calendar year is filed after the proposed rules are published as final regulations in the *Federal Register*. It also is important to note that these new disclosure rules would not apply to gifts governed by IRC §§ 2701 or 2702, as special regulations already cover such Chapter 14 transactions.³¹

The new proposed regulations provide that reported gifts will only be considered as adequately disclosed if the return provides a "complete and accurate description of the transaction including":

1. A description of the transferred property and any consideration received by the transferor;
2. The identity of, and relationship between, the transferor and the transferee;
3. A detailed description of the method used to determine the fair market value of property transferred, including any relevant financial data and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of the transfer of an interest in a closely held entity, a description of any discount claimed in valuing the entity or any assets owned by such entity, including a statement regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), 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. If the entity that is the subject of the transfer owns an interest in whole or in part in another closely held entity, then the same information must be provided for each entity and the assets owned by each entity;
4. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust;
5. Any restrictions on the transferred property that were considered in determining the fair market value of the property;
6. A statement of the relevant facts affecting the gift tax treatment of the transfer that reasonably may be expected to apprise the Internal Revenue Service of the nature of any potential controversy concerning the gift tax treatment of the transfer, or in lieu of this statement, a concise description of the legal issue presented by the facts; and a statement describing any position taken that is contrary to any temporary or final Treasury regulations or revenue rulings.³²

Various compliance issues have been raised regarding the gift tax return SOL and the proposed regulations. As a matter of self-defense, it is expected that return preparers will provide a great deal of additional and unnecessary documentation in an attempt to comply with the vague and overreaching rules. An open question is what else the IRS may require for adequate disclosure of a reported transaction. The proposed regulations state only that the listed items must be "included" in the complete "description of the transaction."

Requirements (i) and (ii) reflect current law. The requirement in (iii) to include any relevant financial data presents at least two reporting conundrums. First, the relevancy standard appears to be far too broad, in that what is merely relevant goes far beyond what may be material to a valuation determination. For example, an appraiser may consider that ten comparable valuations are a sufficient basis for drawing a valuation conclusion, whereas under a pure "relevancy" standard, twenty or even thirty comparables may be relevant. Under this broad standard, almost any reported gift could be attacked years later with the argument that not all relevant financial data was disclosed.

Second, subsection (iii) does not explain what is meant by the term "financial data." However, possible guidance may be found in Treas. Reg. § 301.6501(c)-1(e) (2)(i), which provides that financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the five years immediately before the valuation date.

The additional requirement in (iii) that in the case of any non-actively traded entity the fair market value of 100 percent of the entity be determined without regard to discounts, has been criticized as unnecessary and unrealistic in cases where the value is determined directly by a comparable transaction method. This requirement is not entirely unreasonable in the case of most transfers of less than the entire interest in a closely held business.

Subsection (iii) also requires that the same disclosures be made for all entities involved in a tiered entity transfer. The cost of appraisals and business valuations could be very high. Further, due to the amount of time required to obtain all requested valuations, extended returns may become the rule.

Regarding requirement (iv), a copy of the trust should suffice. However, the proposed regulations require a "brief description," the lack of which may cause the return to fail the adequate disclosure test. No guidance is provided as to what information the description should contain.

Requirement (vi) is the most troublesome. Requirement (vi) provides two disclosure alternatives, both intended to inform the IRS of controversial legal issues presented by the return as filed. This requirement virtually forces taxpayers to rely on the assistance of legal counsel in preparing a GTR. Even if counsel is employed, it will be all but impossible to comply with the open-ended requirement of either stating all relevant facts expected to apprise the IRS of potential controversies or describing any legal issues presented by the facts.

Few experts could or would agree as to the sufficiency of either disclosure. Legal scholars cannot agree as to what is a fact. For example, the comments to the Colorado Rules of Professional Conduct state that whether a particular statement in a negotiation should be regarded as one of fact should depend on the circumstances; and further that statements regarding estimates of price or value placed on the subject of a transaction are not ordinarily taken as statements of fact.³³

The additional requirement of describing any position contrary to Treasury Regulations or rulings is, at best, overburdensome. Again, a significant amount of subjective analysis will be involved in any such disclosure, leaving the door open for attack at any time, thus defeating the "finality" Congress apparently intended in adding the new SOL sections. In any event, the cost of compliance with requirement (vi) would be prohibitive to most taxpayers. These proposed regulations have purportedly caused the big five accounting firms to question whether they should continue to prepare GTRs.³⁴

A positive aspect of the proposed regulations is that they specifically authorize filing a gift tax return that would not otherwise be required to start the SOL running; for example, where the taxpayer believes the gift is excluded under the annual exclusion.³⁵ Further, transactions may be disclosed that the taxpayer does not consider to be a gift, such as sales, leases, or the performance or receipt of services.³⁶ The proposed regulations also provide that the SOL will run on adequately disclosed incomplete gifts, but only if they are reported as completed gifts.³⁷ Be aware, however, that while the statute of limitations for assessment of gift tax under IRC § 6501 (c)(9) appears to apply to all issues of fact or law (including, for example, the effectiveness of a withdrawal power to qualify for the annual exclusion), the expanded proposed rules for revaluation of gifts do not apply "to adjustments involving issues other than valuation."³⁸

The quandary for the practitioner is that, while these rules are only proposed, the adequate disclosure requirement under IRC § 6501(c)(9) is binding and requires compliance; whatever that may entail.

Conclusion

The GTR has become a pervasive document in modern estate planning. Substantial expertise, caution, and attention to detail must be brought to the task of GTR preparation. Ironically, while it is more important than ever for practitioners to be involved in preparing or, at least, reviewing GTRs, the liability for such preparation may outweigh the benefit to the practitioner. While the new SOL rules purport to add some certainty and finality to the reporting of gratuitous transfers, the uncertainty and difficulty of compliance may overwhelm many taxpayers.

Part II of the article will focus on the GST exemption allocation rules.

NOTES

[1.](#) Internal Revenue Code ("IRC") § 2010(c).

- [2.](#) IRC § 2513(a) (gift election); and IRC § 2652(a)(2) (GST election).
- [3.](#) Standard Federal Tax Reports: Understanding IRS Communications, at ¶ 102 (Sept. 1, 1993).
- [4.](#) *Graham v. Commissioner*, T.C.M. 1995-114.
- [5.](#) Standard Federal Tax Reports: Understanding IRS Communication, *supra* note 3, at ¶ 102.
- [6.](#) For example, the Instructions to Form 706 (Rev. July 1998) provide directions for completion of the new Schedule T (regarding the new Family Owned Business deduction under IRC § 2057) that include interpretations of the law not found elsewhere.
- [7.](#) In particular, see IRC § 2511 and Treas. Reg. § 25.2511.
- [8.](#) See *generally*, ¶ 1960 CCH Financial and Estate Planning, Vol. 1.
- [9.](#) Instructions to Form 709 (Rev. January 1999) at 2; IRC § 2523(e).
- [10.](#) IRC § 2613.
- [11.](#) Treas. Reg. § 25.6019-4.
- [12.](#) *Id.*
- [13.](#) Instructions to Form 709 (Rev. January 1999) at 5, Valuation Discounts.
- [14.](#) Instructions to Form 709 (Rev. January 1999) at 6.
- [15.](#) Treas. Reg. § 25.6075-1.
- [16.](#) Instructions to Form 709 (Rev. January 1999) at 4 .
- [17.](#) Treas. Reg. § 25.6019-1(h).
- [18.](#) Priv. Ltr. Rul. 8144006.
- [19.](#) Treas. Reg. § 25.6161-1.
- [20.](#) IRC § 6651(a).
- [21.](#) IRC § 7203.
- [22.](#) IRC § 6501(c)(9).
- [23.](#) IRC §§ 2504(c) and 2001(f).
- [24.](#) IRC § 6501(a).
- [25.](#) IRC § 6501(b)(1).
- [26.](#) IRC § 6501(c)(1)-(3).

- [27.](#) IRC § 6501(e)(2).
- [28.](#) IRC § 6501(c)(9).
- [29.](#) Proposed Treas. Reg. § 301.6501(c)-1(f).
- [30.](#) Proposed Treas. Reg. § 301.6501(c)-(f)(3) and (4).
- [31.](#) Treas. Reg. § 301.6501(c)-1(e).
- [32.](#) Proposed Treas. Reg. § 301.6501(c)-(f)(2)(i)-(vi).
- [33.](#) Comment to Rule 4.1, Colorado Rules of Professional Conduct.
- [34.](#) Committee Corner, ACTEC Notes at 13 (Summer 1999).
- [35.](#) Proposed Treas. Reg. § 301.6501(c)-1 (f)(5), Example 2.
- [36.](#) Proposed Treas. Reg. § 301.6501(c)-1 (f)(3).
- [37.](#) Proposed Treas. Reg. § 301.6501(c)-1 (f)(4).
- [38.](#) Proposed Treas. Regs. §§ 20-2001-1(b) and 25.2504-2(a).