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TAX NEWS & COMMENT

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IRS MATTERS

RECENT DEVELOPMENTS

The Housing and Economic Recovery Act of 2008 includes a new credit of $7,500 for first-time homebuyers. The credit is refundable, and applies to home purchases made after April 8, 2008 and before July 1, 2009. It operates as a 15-year interest free loan, with one-fifteenth of the credit being reported as additional tax each year beginning in 2010. IR-2008-106.

The credit applies only to a principal residence — not to a vacation homes or rental property — located in the U.S. Taxpayers who have not owned a home during the three-year period preceding their purchase qualify as first-time homebuyers. The credit is

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FROM THE COURTS

Tax Appeals Tribunal Rejects Division's Methodology as Lacking Rational Basis

Finding that the Division's estimated methodology for determining taxable sales lacked a rational basis, the Tax Appeals Tribunal in two recent cases cancelled sales tax assessments. This office handled the appeal in the most recently decided case, *In the Matter of Gulzar A. Khan and Ishtiaq Khan,* DTA Nos. 820701 and 820702 (Sept. 4, 2008).

[Petitioners' corporation operated a service station in Harlem. In estimating repair sales, the Division's auditor relied on an investigator who reported that the corporation's premises included two repair bays and that there were sufficient employees present to operate both bays on a full time basis. Based on

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FROM WASHINGTON

TAX OUTLOOK FOR 2009

Tax Analysis

Historically, Congress is amenable to tax proposals of first-term presidents. Senator McCain proposes making permanent all of the lower individual income tax rates under EGTRRA. Senator Obama would retain the lower rates for most taxpayers, but would restore the pre-EGTRRA rates of 36 and 39.6 percent for high income taxpayers.

Elimination of the capital gains tax, which was proposed by President Bush only a few years ago, now appears remote, even if Senator McCain is elected. Mr. McCain favors retaining the present 15 percent tax on long term capital gains and qualified

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Winning a Sales Tax Dispute in the Division of Tax Appeals

Tax Litigation

With the lure of interest, penalties, and large revenues upon which the sales tax is based, the Department of Taxation aggressively pursues sales tax revenue through audit. To emerge victorious in a sales tax dispute, the taxpayer should be conversant with some important principles involving sales tax litigation.

First, auditors often attack the adequacy of the taxpayer's books and records. Should the Division find these records inadequate, it may resort to "external indices," one of which is a "test period" audit, in which an extrapolation could be made over a lengthy term. Since penalties will also be

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NOTE: TAX & LEGAL ISSUES ARISING IN CONNECTION WITH THE GIFT TAX

I. Calculation of Gift Tax

The term "taxable gift" means the gross amount of gifts made during the year, less (i) the annual exclusion of $12,000 per gift and (ii) any charitable or marital deductions available. Gift tax liability is computed by applying the current rate schedule to cumulative lifetime gifts and then subtracting gift taxes payable (at the current rate schedule) for all gifts made in prior years. IRC §§ 2502, 2505. The unified credit of $345,800 will absorb the gift tax of $345,800 imposed on $1 million in taxable gifts at current gift tax rates. (Page 1, Part 2, Line 7 of Form 709.) The amount of the *available* unified credit

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OCTOBER COMMENT

Installment Sale Reporting of Deferred Exchange Boot

Tax Planning

IRC §453 provides that an "installment sale" is a disposition of property where at least one payment is to be received in the taxable year following the year of disposition. Income from an installment sale is taken into account under the "installment method," whereby income recognized in any taxable year following a disposition equals a proportion of the payments received, that proportion being equal to the gross profit over the total contract price.

IRC §453(f)(6)(C) provides that for purposes of the installment method, the receipt of qualifying property in a

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FROM WASHINGTON, CONT.

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dividends, while Senator Obama appears to favor increasing the capital gains rate to 20 percent. Although Mr. Obama had discussed a higher capital gains rate during the primary season, given the present turmoil in the financial markets, it is unclear whether he would now seek a rate higher than 20 percent.

Neither candidate favors repeal of the estate tax. If no action is taken by Congress, the applicable exclusion amount (AEA) will return to its pre-EGTRRA levels of $1 million after 2010. The AEA is scheduled to increase to $3.5 million in 2009. Senator Obama favors retaining the $3.5 million AEA as well as the maximum estate tax marginal rate of 45 percent. Senator McCain favors increasing the AEA to $5 million, and reducing the highest marginal tax rate to 15 percent. It appears doubtful that Congress would consent to such a significant rate reduction.

Although the estate tax is scheduled to be repealed — for one year — in 2010, Congress will not likely permit that eventuality to occur. One option to increase revenues while decreasing the estate tax is to eliminate the step up in basis at death. This would result in a capital gains tax when inherited property is later sold by beneficiaries. However, this proposal has evoked zealous opposition in the past. There is no reason to expect that reaction to it would be different today. Current planning therefore assumes an exclusion amount between $3.5 and $5 million, and a marginal estate rate at or below 45 percent.

The AMT remains a perennial Achilles' heal for Congress, which is forced to enact yearly "patches" to increase the AMT exemption amount to prevent the AMT, which is not indexed for inflation, from affecting tens of millions of taxpayers. Senator McCain has variously proposed increasing the AMT exemption amount and eliminating the AMT. Senator Obama has proposed extending the 2007 AMT patch, and indexing the AMT exemption amounts for inflation in future years.

The candidates positions differ with respect to the phase out of certain itemized deductions. Currently, certain itemized deductions are phased out for single taxpayers whose AGI exceeds $79,975, and for married couples filing jointly whose AGI exceeds $159,950. In 2008, taxpayers will lose one-third of the required phase out, a reduction from two-thirds in 2006 and 2007. Senator McCain would eliminate entirely the current phase-out of itemized deductions, while Senator Obama would restore the phase out for personal exemptions after the phase out sunsets in 2010.

Both Senators favor eliminating the so-called "marriage penalty" by making marriage penalty relief in EGTRRA permanent and making the permanent $1,000 child tax credit.

Senator Obama favors continuing the exclusion for employer provided health care benefits. Mr. Obama also favors targeted health care tax credits for lower income individuals, and health care tax credits for small business to offset the cost of providing health insurance to employees. Senator McCain favors eliminating the current exclusion, but replacing it with a refundable tax credit of $2,500 for individuals and $5,000 for families.

Senator McCain favors reducing the corporate tax rate to 25 percent from its current 35 percent, while Senator Obama would retain the 35 percent rate and increase the corporate income tax base.

Senator McCain supports an elimination of the ethanol subsidies, reducing federal tax on gas, and allowing a tax credit for zero emission cars. Senator Obama favors expanding renewable energy and conservation tax incentives, but repealing tax incentives for oil companies.

The Senate, on September 24th, voted 93-2 to approve legislation extending AMT relief at a cost of $64 billion, without offset. The bill also includes $18 billion in clean energy incentives, which would be offset by delaying deductions for domestic manufacturing activities of major oil and gas companies. The failure to offset the cost of AMT relief may slow passage in the House.

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Ms. Aminoff recently joined the firm Ms. Aminoff earned her J.D. from Benjamin N. Cardozo School of Law in 2007, with a concentration in property and real estate, and is awaiting admission to the New York State Bar. Ms. Aminoff intends to practice tax, trusts & estates, real estate, tax litigation and estate planning.

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INSTALLMENT REPORTING OF BOOT,

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like-kind exchange is not considered to be "payment." However, a problem arises in connection with exchange funds held by a qualified intermediary (QI) in deferred exchanges. Although the eventual receipt of qualifying like kind property is not considered "payment," the IRS has suggested that exchange funds held by a qualified intermediary at the beginning of the exchange period could be considered as "payment" under Temp. Regs. § 15A.453-1(b)(3)(i). If this were the case, funds held by the QI would render installment reporting of boot gain impossible, even though most of the exchange funds were actually used to purchase qualifying like kind property within the 180-day exchange period.

Fortunately, the final regulations under IRC § 453 provide that the deferred exchange safe harbor regulations under IRC §1031 themselves — rather than the rules proposed in Temp. Regs. §15A.453-1(b)(3)(i) — control in determining whether the taxpayer is in receipt of "payment" at the beginning of the exchange period. Since the *raison d'être* of the deferred exchange regulations under Section 1031 is to insulate the taxpayer from being considered in constructive receipt of exchange funds, this rule would appear to bless installment reporting of boot gain later attributable to exchange funds held by a qualified intermediary not used to purchase replacement property.

However, one important condition must be satisfied for this "override" rule to apply: The taxpayer must possess a "*bona fide* intent" to enter into a deferred exchange at the beginning of the exchange period. Regs. §1.1031(k)-1(k)(2)(iv) state that a taxpayer possesses a *bona fide* intent to engage in an exchange only if it reasonable to believe at the beginning of the exchange period that like kind replacement property will be acquired before the end of the exchange period. If the intent requirement is met, gain recognized from a deferred exchange structured under one or more of the safe harbors will qualify for installment method reporting (provided the other requirements of Sections 453 are met.) The rationale for this rule appears to be that without the *bona fide* intent requirement, a taxpayer without a true intention to consummate a like kind exchange could engage the services of a qualified intermediary, not acquire replacement property within the exchange period, yet defer gain recognition until the following year under the installment method.

To illustrate the operation of this rule:

On November 1st, 2008, QI, pursuant to an exchange agreement with New York taxpayer (who has a *bona fide* intent to enter into a like kind exchange) transfers the Golden Gate Bridge to cash buyer for $100 billion. The taxpayer's adjusted basis in the bridge is $75 billion. The exchange agreement provides that taxpayer has no right to receive, pledge, borrow or otherwise obtain the benefits of the cash being held by QI until the earlier of the date the replacement property is delivered to the taxpayer or the end of the exchange period. On January 1st, 2009, QI transfers replacement property, the Throgs Neck Bridge, worth $50 billion, and $50 billion in cash to the taxpayer. The taxpayer recognizes gain to the extent of $25 billion. However, the taxpayer is treated as having received payment on January 1st, 2009, rather than on November 1st, 2008. If the other requirements of Sections 453 and 453A are satisfied, the taxpayer may report the gain realized in 2008 under the installment method.

[**Note:** If the QI had failed to acquire replacement property by the end of the exchange period, and had distributed $100 billion in cash to taxpayer on May 1st, 2009, Regs. §1.1031(k)-1(j)(2)(iv) would still permit gain to be reported on the installment method, since the taxpayer had a *bona fide* intent at the beginning of the exchange period to effectuate a like kind exchange. **Note also:** Under its "clawback" rule, California will continue to track the deferred gain on the exchange involving the Golden Gate Bridge. If the taxpayer later disposes of Throgs Neck Bridge in a taxable sale, California will impose tax on the initial deferred exchange. This will result in the taxpayer paying both New York (6.85 percent) and California (9.3 percent) income tax, in addition to New York City (3.65 percent) and federal income tax (15-25 percent, depending on the extent of unrecaptured Section 1250 gain) on the later sale.]

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phased out for joint filers whose AGI is between $150,000 and $170,000, and for others whose AGI is between $75,000 and $95,000. The credit is claimed on new Form 5405.

¶ Final Regs under IRC §408A provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. The effective date of the final regulations is July 29, 2008. T.D. 9418.

¶ Proposed Regs were issued providing guidance on the manner in which an S corporation reduces its tax attributes under IRC §108(b) for taxable years in which the S corporation has discharge of indebtedness income that is excluded from gross income under IRC §108(a). Reg-102822-08.

¶ Rev. Proc. 2008-36, modifying and superseding Rev. Proc. 2002-9, provides guidance concerning automatic consent procedures by which taxpayers may obtain the Commissioner's consent to make changes in accounting.

¶ Rev. Proc. 2008-54 provides guidance under §§ 102 and 103 of the Economic Stimulus Act of 2008 concerning IRC §179 deductions. The Stimulus Act provides a 50 percent additional first year depreciation deduction for certain new property acquired and placed in service during 2008.

¶ PLR 200805012 stated that transferable development rights (TDRs) granted by a city were "like kind" to improved or unimproved land. In reaching this conclusion, the IRS relied on an analysis of state law. Previous rulings had held that air rights were also of like kind to real property.

¶ A recent IRS study shows large gaps between reported and true income among several groups. The study concludes that (i) while 99 percent of wages reported on income tax returns match verification reports provided by employers, only about half of Schedule C profits are reported; (ii) only 88 percent of capital gains are reported (only the amount realized is reported; investors are trusted to maintain accurate basis records); and (iii) while taxpayers reporting "negative" income garner little audit attention, some such taxpayers — among them full time real estate professionals — report negative income annually. The Joint Committee on Taxation in a 2007 report concluded that most under reporting of capital gains was made by taxpayers claiming to be in the 15 percent bracket but who should be in a higher bracket. [IRS National Research Compliance Study, 2008]

¶ Proctor & Gamble has commenced a refund suit seeking to recover $435 million in paid taxes. P&G claims the IRS improperly limited deductions for technologies donated to universities, medical centers and research foundations. In one example, P&G donated technology for anti-periodontal disease rinse to Columbia

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"prior audit experience," the auditor estimated that each bay generated sales of $130 per hour, and multiplied that figure by two bays used eight hours per day, six days per week, resulting in total estimated repair sales of $648,960 for the audit period. The ALJ found that Petitioners' failure to produce books and records justified resort to estimated methods employed by the Division. Finding unsubstantiated the Petitioners' assertion that the Division's estimated repair sales were too high, the Division of Tax Appeals issued a Determination upholding the assessments for both fuel sales and repair sales. Exceptions were filed and the instant appeal ensued.]

In its decision, the Tax Appeals Tribunal made the following additional finding of fact: "When the auditor met with Mr. Khan for 3.5 hours on May 30, 2003, he was not asked any questions about his gas station's hours of operation, the number of employees, the number of mechanics, or whether they were full or part time. . . The [investigator's] report indicates that, as of the date of the report (8/8/02), the business had four employees, but does not specify that they are mechanics. The report states that there were nine customers during the time of the visit, but fails to show how long each visit lasted or what type of customers are referred to."

On appeal, Petitioners took issue with the sales tax imposed on repairs, arguing that the method employed by the Division in calculating estimated tax on repair sales lacked a rational basis. Petitioners also argued that the Division's estimate of the scope and extent of Petitioners' repair work and the amount of time the repair bays were operated was excessive. The Division argued that the Determination should be sustained, citing three cases involving one-day observation tests and prior audit experience.

In its opinion, the Tribunal first cited *Matter of Grecian Square v. Tax Appeals Tribunal,* 119 AD2d 948 (1986) for the proposition that "a determination of tax must have a rational basis in order to be sustained." The Tribunal noted that "[w]hile considerable latitude is given to an auditor's method of estimating sales under such circumstances as may exist in a given case, it is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis." In *Grecian Square*, the record lacked testimony concerning the applicability of the audit experience to the tavern in question. The Tribunal remarked that such information "is necessary to provide the taxpayer with an opportunity to meet their burden of proving such methodology is unreasonable."

The Tribunal observed that the Division's investigator noted in his report: "A busy service station with a two bay repair shop. No convenient (sic) store. Few Tires." However, the Tribunal reasoned that the fact that the taxpayer had "sufficient employees" to operate two repair bays "does not mean that both repair bays were busy when he was there." The Tribunal also noted that report failed to quantify how many employees were "sufficient". The Tribunal found the "lack of curiosity" of the auditor in inquiring as to the type of repair sales "troubling," and remarked somewhat caustically that the auditor's assertion that the "taxpayer['s station]

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WINNING IN DIVISION OF TAX APPEALS,

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extrapolated, this is a dangerous position for the taxpayer to be in.

The first question is whether the Division was justified in resorting to external indices. The Division must make an *explicit request* for books and records for the entire audit period. If only a "weak and casual" request is made for records (*Matter of Christ Cella*, 477 NYS2d 858), the taxpayer may be excused from having failed to provide records. If the auditor failed to conduct a sufficient examination of the records, the use of a test period audit has been held improper. Does the audit report actually document a finding of inadequacy of records? *Matter of King Crab*, 522 N.Y.S.2d 978. If not, the Division may be unable to establish inadequacy of records. Resort to a test period audit is not justified unless it is "virtually impossible" to determine tax based upon available records. *Matter of Chartair*, 411 NYS2d 41. Did the auditors fail to review books and records because they were "too voluminous"? *Matter of Names in the News*, 429 NYS2d 755. The Division may not employ an "economic feasibility" test in resorting to a test period audit. The taxpayer has a right to a detailed audit under Tax Law §1138. *Matter of Chartair, supra.*

Did the taxpayer or his representative actually consent to a test period audit? Merely complying with a request to provide records for a test period does not, without more, evidence a waiver of the taxpayer's right to a complete audit. *Matter of James G. Kennedy*, 509 NYS2d 199. Did the Division "deliberately overlook" records which were helpful to the taxpayer? *Matter of Merrick Discount Center*, DTA No. 800362. Was there a change in auditors? Did the original auditor appear at the hearing or at least provide an affidavit? If not, the evidence may not be sufficient to justify resort to external indices. *Matter of Kenneth Schuck Trucking*, DTA No. 816129. If the audit period was extended, were those records requested? Was an independent review of records relating to the extended audit period made? If adequate records exist for the extended audit period, the Division "cannot ignore them." *Matter of Adamides*, 521 NYS2d 826.

Even if the taxpayer failed to comply with the Division's record keeping regulations, it may not "prescribe the type of proof that a taxpayer must provide at hearing" in order to prevail. *Matter of John G. Avildsen*, DTA No. 809722. If the amount of tax paid was "easily ascertainable" from records provided, a denial of credit by the Division was held to constitute the "mindless elevation of form over substance" and could not be considered "anything other than an arbitrary and capricious exercise of power." *Matter of Riluc*, 565 NYS2d 265. Did the Division request records not typically kept by persons involved in the taxpayer's line of business? If so, the taxpayer has the right to substantiate the proper collection of tax due through supporting documents. *Matter of Raemart Drugs*, 555 NYS2d 458.

Assuming resort to estimate procedures was warranted, did those procedures lack a "rational basis," or did an extrapolation yield a grossly inaccurate estimate the tax liability? *Matter of Yonkers Plumbing*, 403 NYS2d 792. Was the Division's method "reasonably calculated" to reflect the taxes due? *Matter of W.T. Grant Company*, 2 NY2d 196, *cert denied* 355 US 869. Was the audit methodology founded upon the auditor's "experience" without any indication that the experience relates to the present audit? *Matter of Grecian Square*, 119 AD2d 948. Was the method chosen by the Division to estimate sales arbitrary and capricious? *Matter of King Crab, supra.*

Was the imposition of penalties proper? Did the taxpayer make a "reasonable effort" to ascertain tax liability? *Matter of Northern States Contracting, Inc.,* DTA 806161. Was any understatement of tax unintentional? *Matter of G & R Machinery*, DTA 804590. As these cases demonstrate, knowledge of the taxpayer's substantive rights constitutes the best insurance against an unfavorable result. Having a meritorious case may unfortunately be insufficient to prevail at hearing unless the proper legal arguments are advanced.

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LEGAL ISSUES INVOLVING GIFT TAX,

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in a given taxable year is $345,000 reduced by the aggregate amount of the unified credit utilized (or available) in previous periods. (Form 709, Page 1, Part 2 "Tax Computation," Line 9.)

The unified credit reduces dollar-for-dollar the amount of gift tax liability. (Form 709, Page 1, Part 2 "Tax Computation," Line 15; IRC §2502; instructions p. 12). Current gift tax liability arises once the cumulative total of lifetime gifts exceeds $1 million. IRC §2505. The rate of tax imposed on cumulative adjusted taxable gifts is graduated. (Instructions, p. 12, "Table for Computing Gift Tax"; Form 709, Page 1, Part 2 "Tax Computation," Line .) Once the $1 million threshold is crossed, the rate of tax imposed is 41 percent. IRC §2502; instructions, p. 12, "Table for Computing Gift Tax". (The first $1 million is subject to gift tax at a rate of 34.6 percent, but tax liability of $345,800 is credited out by the unified credit of $345,800.) The highest marginal gift tax rate in 2008 is 45 percent. ("Table for Computing Gift Tax Instructions, p. 12".) The highest marginal gift tax rate is scheduled to decrease to 35 percent in 2010. In 2011, when EGTRRA "sunsets," the highest gift tax rate is scheduled to return to 55 percent.

The sum of all post-1976 gifts are "adjusted taxable gifts," and are added to current gifts for the purpose of determining current gift tax liability. The marginal rate imposed on a current year's gifts reflects aggregate taxable gifts for all periods. Therefore, the marginal rate imposed on gifts made by a taxpayer who has made gifts of $500,000 in previous years will be higher than the rate imposed on a taxpayer who has made no previous gifts, even if each makes the amount of gifts in the current year. Gifts are not taxed twice `because earlier gift taxes are credited when determining current gift tax liability.

Form 709 requires the date of the gift to be indicated on the return. (Form 709, Page 2, Schedule A, "Computation of Taxable Gifts, Part 1, Column E.) This is important because certain gifts, and the gift taxes paid on those gifts, are included in the gross estate should the donor die within three years of making the gift. IRC §2035. *See infra*, Part X.

Nonresident aliens are subject to gift and GST taxes for gifts of real property and tangible personal property located in the United States. Under some circumstances, nonresident aliens are subject to gift and GST tax for gifts of intangible property. IRC §2501(a). Nonresident aliens may not claim the unified credit, and must enter "0" on Page, 1, line 11 of Form 709 containing the preprinted number "$345,800", which is the unified credit available for residents. (Instructions, p. 11).

Illustration. Donor, a United States resident who had made no previous taxable gifts, made gifts of $100,000 in 2006 and 2007. On his 2006 return, donor reported the gift of $100,000 and the gift tax liability of $23,800. (Instructions, p. 12, "Table for Computing Gift Tax"). Donor's unified credit of $345,800 was reduced by $23,800, to $322,000. On donor's 2007 return, a gift tax liability of $31,000 was reported, representing the difference between (i) $54,800 (gift tax liability calculated at current rates for cumulative taxable gifts for all periods) and (ii) $23,800 (gift tax liability at current rates for adjusted taxable gifts for previous periods). The 2007 gift tax liability of $31,000 further reduced the available unified credit from $322,000 to $291,000.

II. When Obligation to Report Arises

The gift tax is an excise tax imposed upon gratuitous transfers of "property". Payment of the tax is the personal responsibility of the donor, although secondary liability may attach to the donee if the donor fails to pay. Treas. Reg. §25.6151-1. In property law, a completed gift requires three elements: First, the donor must **intend** to make a gift. Second, the donor must **deliver** the gift to the donee. Third, the donee must **accept** the gift. Whether these elements have been met is a question of local law. Although Congress (and the IRS) has dispensed with the requirement of donative intent, courts have generally required all three elements to be present before a transfer may be taxed as a gift. *W.H. Wemyss*, 324 U.S. 303.

Generally, the requirement of filing a federal gift tax return arises only when one has made a *completed* taxable gift. A gift is complete when the donor has so parted with control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. Treas. Reg. §25.2511.2(b). Incomplete gifts impose no gift tax filing requirement. Gifts are valued as of the date of the gift. IRC §2512. No gift tax return is required for (i) gifts not in excess of the annual exclusion; or (ii) gifts to a charity during a taxable year where no other reportable gifts during the year were made; or (iii) outright gifts to spouses which qualify for the unlimited marital deduction. IRC §6019. IRC §102 explicitly provides that gifts are excluded from the gross income of the donee.

If consideration is received by the donor in connection with the transfer, a sale has occurred, in addition to a gift. Treas. Reg. §25.2512-8. This necessitates payment of income, as well as gift, tax. However, a transfer made "in the ordinary course of business" lacking donative intent will not produce a taxable gift. If the donee is required, as a condition to receiving the gift, that he pay gift tax associated with the gift, the gift tax paid reduces the value of the gift for gift tax purposes. Yet the gift tax payable itself depends on the amount of the gift. Since the two variables are dependent upon one another, their calculation requires the use of simultaneous equations. The donor must report as taxable gain the excess of the gift tax payable over adjusted basis, since the Supreme Court determined that the gift tax payable is an "amount realized." *Diedrich v. Com'r*., 50 AFTR 2d 82-5054.

If the donor is legally incompetent, an agent may sign and file a gift tax return. Treas. Reg. §25.6019-1(g). In this case, a statement must accompany the return. Treas. Reg. §25.25.6019-1(h). If the donor regains competency, he must ratify the agent's statement within a reasonable time. Treas. Reg. §25.6019-1(h).

Generally, no duty exists to file an amended return. The Supreme Court, in *Hillsboro National Bank v. Com'r*., 460 U.S. 370 (1983), remarked that "the Internal Revenue Code does not explicitly provide either for the taxpayer's filing . . . of an amended return; instead, an amended return is a creature of administrative grace and origin." If a gift was omitted from a previous return, it should be reported on Form 709, Schedule B, p. 3 ("Gifts From Prior Periods") as part of all gifts for previous years. Treas. Reg. §25.2504-1(d). In some cases a decedent has failed to file required gift tax returns during his lifetime. The Executor must make a reasonable inquiry as to such gifts, and the preparer should advise the Executor of this responsibility. (Instructions to Form 706, p. 4.)

III. Basis Issues

Form 709 requires a statement disclosing the adjusted basis of gifted property. (Form 709, p. 2, Schedule A, Part 1, Column D.) No actual calculation of basis is required. Without a disclosure of basis, the return may not be accepted as filed. Treas. Reg. §1.1015-1(g) provides that persons making or receiving gifts should preserve and keep accessible a record of facts necessary to determine the cost of property and its fair market value as of the date of the gift.

The basis of property acquired by gift is determined by reference to the basis of the property in the hands of the donor. IRC §1015. However, if the fair market value of the property at the time of the gift is less than the donor's basis, then for purposes of

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determining the donee's loss on a later sale, basis is limited to that fair market value. IRC §1015(a); Treas. Reg. §1.1015-1. With respect to gifts of a life estate or a term of years, gain or loss from a sale or other disposition is determined by comparing the amount of the proceeds with amount of the basis which is assignable to the transferred interest. Treas. Reg. §1.1014-5(a)(1).

A fraction of the gift tax **paid** (not the gift tax liability, which may be reduced by the unified credit) by the donor will operate to increase the basis of the transferred property in the hands of the donee. IRC §1015(d). That fraction is expressed as follows:

Property Appreciation to Date of Gift
FMV of Property at Date of Gift

Illustration. Donor's adjusted basis in property is $100,000. Donor, who has made no previous taxable gifts, gifts property at time it is worth $2,012,000. A gift tax liability of $780,800 arises (*i.e.*, gift tax imposed on "includible" gift of $2 million after application of annual exclusion but before the unified credit). The appreciation during the relevant time expressed as a fraction is .9503 (*i.e.*, $1,912,000/ $2,012,000). Therefore, of the $435,000 gift tax paid ($780,000 tax liability less unified credit of $345,800), $413,380 will effect an increase in the donee's basis, resulting in a basis to the donee of $513,380 (*i.e.,* $413,380 + $100,000).

If a decedent makes a testamentary bequest (or devise) of property to the person from whom he acquired such property by gift within one year of the decedent's death, no step-up in basis will be allowed. Instead, the basis of the property in the decedent's estate will be limited to the decedent's basis in property before his death. IRC §1014(e).

IV. Time Periods For Filing Returns

Except in the case where the donor dies early in the year, Form 709 is required to be filed by April 15th in the taxable year following the year of the gift, unless an extension is requested. If the donor dies early in the year of the gift, the estate tax return may be due prior to April 15th of the following year. In that case, the Executor must file Form 709 no later than the earlier of (i) the due date (with extensions) for filing the donor's estate tax return; or (ii) April 15th of the following year, or the extended due date granted for filing the donor's gift tax return.

If no gift tax is owed, a six month automatic extension sought for filing an income tax return on Form 4868 will also automatically extend the period for filing a Form 709 gift tax return until October 15th. However, if gift tax is owed, or if no income tax extension is sought, Form 8892, requesting an automatic 6 month extension in which to file Form 709, must be used. The grant of an extension for filing a return does not operate to extend the time for payment. Any gift tax not paid on or before the due date (without regard to extensions) will attract interest at the underpayment rate established by IRC §6621(a)(2). IRC §6601 (a). Estimated payments of gift tax are not required.

Under revised IRC §6694, a return preparer (or a person who furnishes advice in connection with the preparation of a return) is subject to substantial penalties if he does not have a reasonable basis for concluding that the position taken was *more likely than not.* If the position taken is not more likely than not, penalties can be avoided by *adequate disclosure*, provided there is a reasonable basis for the position taken. Under prior law, a reasonable basis for a position taken means a one-in-three chance of success.

The IRC §6694 penalty applies to all tax returns, including gift and estate tax returns. The penalty imposed is $1,000 or, if greater, one-half of the fee derived (or to be derived) by preparer. An attorney who furnishes a legal opinion is deemed to be a non-signing preparer. The fees upon which the penalty is based for a non-signing preparer could reference the larger transaction of which the tax return is only a small part. Notice 2008-13 provides that until the revised regulations (expected before the end of 2008) are issued, a preparer can generally continue to rely on taxpayer and third party representations in preparing a return.

Treas. Reg. §25.2504-2(b) provides that gifts "finally determined" cannot be revalued. The value of a gift is finally determined if (i) the three-year period under IRC § 6501 to assess the gift tax has expired and (ii) the gift has been adequately disclosed on the gift tax return. Therefore, even if no gift tax is currently owed, the filing of Form 709 serves the important purpose of commencing the statute of limitations for the time in which the IRS may seek to revalue the gift. Treas. Reg. §301.6501(c)-1(f)(5) provides that adequate disclosure of a transfer as a completed gift will commence the statute of limitations for assessing a gift tax (and revaluing the gift) even if gift is later determined to be incomplete under Treas. Reg. §25.2511-2.

Thus, once a return has been timely filed and the period of limitations for assessing gift tax has expired, the IRS may not revalue the gift for the purpose of collecting additional tax with respect to that gift. However, the IRS may revalue the earlier transfer for purposes of determining cumulative "adjusted taxable gifts." Treas. Reg. §25.2504-2. Although this revaluation will not result in additional tax liability with respect to the initial gift, the marginal tax rate imposed on later gifts could be higher.

V. Annual Exclusion Gifts

Gifts qualifying for the annual exclusion, currently $12,000, are neither reported nor taxed, if only annual exclusion gifts are made during the taxable year. IRC §2503(b). Any number of annual exclusion gifts may be made by a donor to any number of separate donees. Annual exclusion gifts will appear on Form 709 (if otherwise required to be filed), as they can be applied to reduce taxable gifts (to separate donees) in excess of $12,000. (See Form 709, p. 3, Schedule A, Part 4, "Taxable Gift Reconciliation," Lines 2 and 5.) The gross amount of the gift, less the annual exclusion, yields the "includible" gift.

Annual exclusion gifts must be gifts of a present interest, meaning that the donee must have all immediate rights to the use, possession and enjoyment of the property or income from the property. Gifts consisting of a future interest, *i.e.,* gifts in which the donee's right to use, possess or enjoy the property will not commence until a future time, will not qualify for the annual exclusion. Treas. Reg. §25.2503-3. The present interest must be a present *possessory* interest, meaning the beneficiary must have a present right to enjoy the property. *Hackl v. Com'r.*, 2003-2 USTC ¶60,465, 335 F3d 664 (7th Cir. 2003, *aff'g* 118 TC 279).

The IRS has defeated attempts to circumvent the "per donee" limitation of the annual exclusion. Under the reciprocal trust doctrine, where two persons make gifts to their own children as well as to the children of siblings, the number of annual exclusion gifts will be limited to gifts made to one's own children. *Estate of Schuler v. Com'r.*, F3d 575 (8th Cir. 2002). Similarly, one cannot increase the number of annual exclusions by the expedient of engaging intermediaries. *Heyen v. U.S.*, 945 F2d 359 (10th Cir. 1991).

VI. Regulatory Extensions

Extension of time periods provided by regulation, revenue ruling, notice or announcement may be requested under Reg. §301.9100-3. To request such a regulatory extension, the taxpayer must demonstrate that he acted reasonably and in good faith and that the interest of the government will not be prejudiced. However, requests for

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extensions of statutory deadlines cannot be made.

Treas. Reg. §25.6161-1 provides for an extension of time (not to exceed six months from the date fixed for the payment of the tax) to pay the gift tax if a request therefor is made by the donor to the district director. The grant of an extension of time to pay gift tax will not relieve the donor of liability for the payment of interest during the period of the extension. IRC §6601; Treas. Reg. §301.6601-1. However, penalties will not accrue during the period of the extension.

An application for an extension of time to pay the gift tax must be in writing and must demonstrate that "undue hardship" would result if the extension were refused. The application must be accompanied by a statement indicating the assets and liabilities of the donor and an "an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the amount to which the application relates." The application will acted upon by the district director within 30 days.

The gift of cash (currency or coin) by a nonresident alien would constitute a gift of tangible personal property subject to gift tax. Rev. Rul. 78-360. However, a gift of the same amount by check (a negotiable instrument) would constitute the gift of an intangible, and would not be subject to the gift tax. The instructions (p. 11) provide that a credit for a payment of foreign gift tax may be claimed with respect to the following six countries with whom a convention is in effect: Australia, Austria, Denmark, France, Germany, Japan, Sweden and the United Kingdom. The amount of the credit is determined by the applicable convention. (Form 709, Page 1, Part 2, line 13).

VII. Split Gifts by Spouses

Unlike the rules relating to income tax returns, there is no provision for the filing of "joint" gift tax returns. However, under IRC §2513, spouses may "split" gifts. By splitting a gift, both spouses are deemed to have made one-half of the taxable gift, regardless of which spouse actually transferred the property. Each spouse's taxable gift is reduced by half. (Form 709, Page 2, Schedule A, "Computation of Taxable Gifts, Part 1, Column G.) The effect is to double the available annual exclusion gifts and to reduce the marginal gift tax rate. Also, by splitting gifts, each spouse's unified credit may be tapped. (Form , Page 2, Schedule A, "Computation of Taxable Gifts, Part 1, Column G.) At the time of the transfer, the spouses must both be United States residents. In addition, at the time of the gift for which the election is being made, the donor must be married to the person who consents to the gift-splitting and must not remarry before the end of the year.

The spouse making the gift is required to elicit the signature of the spouse consenting to split the gift. (Form 709, Page 1, Part 1, "General Information," Lines 12 through 18.) This signature would evidence the formal consent to the splitting of the gift. The executor or administrator of a deceased spouse, or the guardian of a legally incompetent spouse, may validly consent to split a gift. Treas. Reg. §25.2513-2(c). The consent to split gifts may not be made after the gift tax return has been filed. If both spouses make gifts during the year and are required to file gift tax returns, both spouses would consent to splitting gifts on the other spouse's gift tax return. Each would also indicate on his own return the total amount of gifts made by the other spouse. (Form 709, Page 2, Schedule A, "Computation of Taxable Gifts, Part 1, "Gifts Made by Spouse."). The IRS suggests filing both returns in the same envelope to assist in processing the returns.

With three exceptions, once a spouse consents to split a gift, the consent will apply to all gifts made during the year. Treas. Reg. §25.2513-1(b). Under the first exception, the consent is not effective with respect to a portion of the year in which the spouses were not married. Under the second, the consent is not effective during the part of a year in which the consenting spouse was not a United States resident. Finally, the consent is not effective with respect to the gift by one spouse of property over which he created in the other spouse a general power of appointment. Treas. Reg. §25.2513-1(b).

Under IRC §2513(b), consent to split gifts may not be signified (i) after April 15th, unless before April 15th no return has been filed, in which case consent may not be signified after a return for such year is filed by either spouse; or (ii) after a notice of deficiency has been issued pursuant to IRC §6212(a). If consent was signified prior to April 15th by the filing of a return, consent may be revoked prior to April 15th by filing a statement of revocation. A consent not signified until after April 15th may not be revoked, even if the consent was filed after April 15th and the revocation was filed before October 15th. Treas. Reg. §25.2513-3(a)(1).

Consenting to split gifts attracts joint and several gift tax liability for both spouses for the entire gift tax for each year in which the consent has been made. Treas. Reg. §25.2513-4. However, consenting to split a gift will not result in estate tax inclusion in the consenting spouse, even if the property is later included in the estate of the donor spouse.

VIII. Transfers Excluded By Congress

Certain transfers, which would otherwise constitute taxable gifts, have been excluded by Congress from the definition transfers subject to gift tax. Since these transfers are not subject to the gift tax, no deduction is available (or needed). Thus, under IRC §2503(e), the gift tax does not apply to "qualified transfers" made directly to (i) political organizations as defined in IRC §527(e)(1); (ii) "qualifying domestic or foreign educational organizations as tuition" (*See* IRC §170(b)(1)(A)(ii)); or to (iii) to medical care providers as defined in IRC § 213(d) for the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation primarily for and essential to medical care" of any person. (no relationship requirement).

At times, consideration may be paid by one spouse in connection with transfers made in the context of a divorce settlement. IRC §2516 provides that transfers between spouses, or between former spouses if the transfer is incident to divorce, and made pursuant to a written agreement will be deemed to have been made for full and adequate consideration provided (i) the transfer is in settlement of property rights or (ii) is intended to provide a reasonable allowance for the support of issue of the marriage during minority. In the income tax context, IRC §1041(a) provides that no gain or loss is recognized on the transfer of property between spouses, or between former spouses if the transfer is incident to divorce. However, since no gain is recognized, IRC §1041(b) requires the donee to take a substituted basis in the property.

A donee's refusal to accept a gift (or bequest) will result in the donee (the "disclaimant") being treated as not having received a gift and no transfer having occurred. To constitute a "qualified disclaimer" under IRC §2518, the refusal to accept the gift must be irrevocable, unqualified, and in writing, and must be received by the donor (or his legal representative) within nine months after the later of (i) the day on which the transfer creating the interest was made or (ii) the day when the disclaimant reaches the age of 21. In addition, the disclaimant must not have accepted the interest or any of its benefits. Finally, the interest must pass without any direction from the disclaimant to the spouse of the decedent or a person other than the disclaimant. If a valid disclaimer is made for federal tax purposes, the disclaimant is treated as if he had predeceased the donor.

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IX. Marital and Charitable Gifts

Outright gifts to spouses qualify for the unlimited marital deduction under IRC §2523(a). The deduction is limited to the amount of the "includible gift," which is the amount of the gift in excess of the annual exclusion. IRC §2503(b); Form 709, Page 3, Schedule A, Part , "Taxable Gift Reconciliation," Lines 4 and 5. Filing of a gift tax return is not required for outright gifts qualifying for the unlimited marital deduction. However, if a return is filed reporting other gifts, all marital gifts must be reported, even those which qualify for the unlimited marital deduction. Gifts made to a nonresident spouse do not qualify for the unlimited marital deduction. However, such gifts qualify for an annual exclusion of $125,000. IRC §2523(i).

Gifts to a spouse of a terminable interest consisting of a life estate, an estate for a term of years, or any other property interest that will, *with respect to the donee spouse,* terminate or fail after a period of time, are not deductible, and require the filing of a gift tax return. Outright gifts of some terminable interests, such as a patent, whose value eventually becomes worthless, will qualify for the unlimited marital deduction, provided the interest of the donee spouse will not terminate.

Provided the following four conditions are satisfied, the gift of a life estate with power of appointment will qualify for the marital deduction: (i) the spouse possesses an exclusive lifetime income interest in the property; (ii) income is paid no less frequently than annually; (iii) the donee spouse is granted a lifetime or testamentary power to appoint the entire interest; and (iv) no part of the interest is subject to another person's power of appointment. A return is required to report the gift of a life estate with power of appointment only if other other marital gifts require reporting.

Property remaining in the life estate with power of appointment trust would be included in the estate of the donee spouse by virtue of the lifetime or testamentary power of appointment possessed by the donee-spouse. The amount includible is the fair market value of the remaining property at the death of the donee-spouse. The estate of the donee-spouse receives a basis step up for anything included in his or her estate pursuant to IRC §1014(b)(4).

If the transfer constitutes a qualified QTIP transfer and an election is made whereby the property is included in the estate of the donee spouse upon his or her death, a deduction will be permitted. IRC §2523(f). The QTIP rule permits the donor to deduct the value of the gift, yet retain the right to determine who ultimately receives the property. The QTIP is often used in second marriage situations. To effectuate a valid QTIP transfer, the donee spouse must possess a "qualifying income interest for life" which is similar to that in the power of appointment trust, but differs in that the donor may specify who will ultimately receive the property.

The QTIP election must be made pursuant to IRC §2523(f). The election may not be made on a late filed From 709. The QTIP election is made by listing the qualified terminable interest property on Form 709, Page 2, Schedule A and deducting its value in Schedule A, Part 4, line 4. The instructions (p. 10) state that "you are presumed to have made the election for all qualified property that you both list and deduct on Schedule A." (Form 709, p. 3, "Terminable Interest (QTIP) Marital Deduction.) If the donor does not wish to elect QTIP treatment, he would simply not deduct the value of the QTIP property on the gift tax return on Form , Page 3, Part 4, Line 4.

Although the QTIP deduction will be the fair market value of the property at the time of transfer to the spouse, the amount includible in the estate of the donee spouse at death is the fair market value at the death of the surviving spouse. The basis of the property will be stepped up to fair market value at the date of death of the donee-spouse by virtue of its inclusion in the estate of the donee spouse. IRC §1014(b)(10).

Since outright gifts to spouses are fully deductible, it may be desirable for a spouse with more assets to transfer assets to a spouse with fewer assets to avoid wasting the estate tax unified credit available at the death of either spouse. Since the property will also be included in the gross estate, it will receive a step up in basis.

As with gifts qualifying for the unlimited marital deduction, the charitable deduction is also unlimited. The amount of the deduction is equal to the "includible gift," which is the amount of the gift less the annual exclusion. IRC §2524. Under IRC §2522, a gift tax deduction is available for contributions to, *inter alia*, (i) the United States or any subordinate level of government, or (ii) a corporation, trust fund, etc., organized exclusively for religious, charitable, scientific, literary, or educational purposes (*i.e.*, IRC §501(c)(3) organizations). Under the gift tax rules, a charitable deduction contribution is available for transfers made to foreign charitable organizations. No correlative deduction is available under the income tax rules. Charitable gifts may also qualify for an income tax deduction. IRC §170. However, although the amount of the income tax deduction is limited, the charitable deduction for gift (and estate) tax purposes is not. If the donor's only gifts during the year were to made to charities, no gift tax return need be filed. However, if the donor is required to report noncharitable gifts, gifts made to charitable entities must be reported on the return, along with a corresponding deduction. (Instructions, p. 2.)

X. Other Gratuitous Transfers

Some lifetime gifts which requiring reporting may not involve a "transfer" in its ordinary sense. Treas. Regs. §25.2511-1(a) include several examples: (i) forgiveness of debt; (ii) assignment of benefits of a life insurance policy; (iii) transfer of cash; and (iv) transfer of federal, state or municipal bonds. The gift tax may also apply to a below-market loan, or to certain property settlements in divorce situations (which do not fall within IRC §2516).

Creating joint ownership of a bank account does not result in a taxable gift until the person whose name has been added to the account actually withdraws funds, or until the person initially owning the account dies. Treas. Reg. §25.2511-1(h)(4); Instructions, p. 4. The rationale for this rule is that the donor can reacquire the funds until withdrawn by the other joint owner.

Joint tenancies can be used as a substitute for a will. If the donor converts property owned by him into a joint tenancy by placing another person's name on the deed, in all likelihood the IRS would argue that a gift of one-half of the value of the real estate occurred when the joint tenancy was created. (Although donative intent might be absent if the joint tenancy were created solely to avoid probate.) Treas. Reg. §25.2511-1(h)(4). The person furnishing the consideration for the property is deemed to have made a gift to the other joint tenant(s) in the amount equal to the donee(s) *pro rata* interest in the property. Treas. Reg. §25.2511-1(h)(5). In practice, it appears that some taxpayers fail to file gift tax returns when a joint tenancy in real estate is created.

No gift tax will arise by virtue of creating a joint tenancy between spouses. In many states, including New York, a joint tenancy between spouses is referred to as a "tenancy by the entirety." The creation of a tenancy by the entirety would have no gift tax consequences because of the availability of the unlimited marital deduction. In most states, including New York, a married couple is presumed to take title to property as tenants by the entirety, unless the deed or conveyancing document states that the spouses are taking title as tenants in common. The most important difference

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between a tenancy by the entirety and a joint tenancy is that a tenant by the entirety may not sell or give away an interest in the property without the consent of the other tenant.

Treas. Reg. §25.2511-1(h)(8) provides that if an insured purchases a life insurance policy or pays premiums on a previously issued policy, the proceeds of which are payable to a beneficiary other than his estate, and the insured retains no reversionary interest in himself or his estate and no power to revest economic benefits in himself or his estate, or to change the beneficiaries or their proportionate benefits, the insured has made a gift of the value of the policy, or the premium paid, even though the right of the beneficiary to receive the benefits is conditioned on surviving the insured. Furthermore, the subsequent payment of the premium by the original owner will constitute a gift to the beneficiary. Form 712 (Life Insurance Statement) must be filed with the gift tax return. If the owner does retain the right to change beneficiaries, the transfer is incomplete and no gift occurs.

Gifts of property to a partnership are considered gifts to the partners in proportion to their partnership interest. *Senda v. Com'r.*, 433 F.3d 1044 (8th Cir. 2006).

Under IRC §7872, the transfer of money without adequate interest is deemed to result in a gift of the foregone interest. In the case of a demand loan, the donor is deemed to have made a gift of the interest in each year the loan is outstanding. The foregone interest is determined by calculating the difference between (i) the amount of interest at the short term AFR (Applicable Federal Rate) found in IRC §1274(d) for the period in question and (ii) the amount of interest charged, if any. Under a *de minimis* rule, no gift or income tax consequences result if the loan (or loans to one person) does not exceed $10,000.

The exercise or release of a general power of appointment may also constitute a taxable transfer by the person exercising or releasing the power. IRC §2514(b). For example, if a trust beneficiary releases a power to consume the principal of the trust, this could constitute a taxable gift. The release of a limited power of appointment could result in a taxable transfer unless the donor retained another limited power of appointment or other interest which prevented the transfer from being complete.

XI. Determining the Value of Gift

Treas. Reg. §25.2512-1 provides that the fair market value of property for gift tax purposes is "the price at which such 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 a reasonable knowledge of relevant facts." Reasonable knowledge of the facts includes facts that could be discovered with reasonable investigation. *Estate of Baldwin v. Com'r.*, 18 TCM (CCH) 902 (1959).

The instructions (p.8) provide that value of real property is the price paid in an arm's length transaction before the valuation date. If none exists, comparable sales may be used. Although not required, if an appraisal if obtained, it should be attached to the return. Treas. Reg. §25.2512-1 provides that local property tax values are not relevant unless they accurately represent the fair market value. Treas. Reg. §25.6019-4 provides that a legal description should be such that real property may be "readily identified." This would include a metes and bounds description (if available), the area, and street address.

A real estate appraiser may use one of three valuation methods: (i) comparable sales; (ii) replacement cost; or (iii) capitalization of income (for income producing properties). The IRS may be skeptical of the capitalization of income method since small differences in the capitalization rate may greatly affect value. If an appraisal fails to consider factors which may depress property value (*e.g.*, environmental or title problems), the cost of remediation should be factored into the final gift tax value. *See Estate of Necastro*, TCM 1994-352.

The value of stocks traded on an established exchange or over the counter is determined by calculating the mean between the highest and lowest quoted selling price on the date of the gift. Treas. Reg. §25.2512-2(b)(1). Publicly traded stocks should include the CUSIP (Committee on Uniform Identification Procedure). If no sales exist on the valuation date, the instructions (p. 8) state that the mean between the highest and lowest trading prices on a date "reasonably close" to the valuation date may be used. If no actual sales occurred on a date "reasonably close" to the valuation date, *bona fide* bid and asked prices may be used.

Closely held stocks should be valued by an appraiser, and should include the EIN. Their value is determined by actual selling price. If no such sales exist, fair market value is determined by evaluating the "soundness of the security, the interest yield, the date of maturity and other relevant factors." Treas. Reg. §25.2512-2(f). The instructions (p.8) state that complete financial information, including reports prepared by accountants, engineers and technical experts, should be attached to the return, as well as the balance sheet of the closely held corporation for "each of the preceding five years." Rev. Rul. 59-60, a venerable ruling, sets forth a list of factors to be considered when valuing closely held businesses.

No appraisal is required for tangible property such as artwork, but if one is obtained, it should be attached to the return. Rev. Rul. 96-15 delineates appraisal requirements, which include a summary of the appraiser's qualifications, and the assumptions made in the appraisal. If no appraisal is made, Schedule A must indicate how the value of the tangible property was determined. The history (provenance) of the artwork will greatly affect its gift tax value. As is the case with large blocks of stock, a blockage discount may apply to the gift of large blocks of artwork. *Calder v. Comm.*, 85 TC 713 (1985). The IRS does not recognize fractional interest discounts in the context of artwork, since it believes that there is "essentially no market for selling partial ownership interests in art objects. . ." Rev. Rul. 57-293; see *Stone v. U.S.*, 2007 WL 1544786, 99 AFTR2d -2292 (N.D. Ca. 5/25/07), (District Court found persuasive testimony of IRS Art Advisory Panel, which found discounts applicable to real estate inapplicable to art; court allowed only 2 percent discount for partition.)

Treas. Reg. §25.2512-6(a) provides that the value of a life insurance contract is determined by the sale price of the particular contract by the company, or by the sale of a comparable contract on the gift date. Where the policy has been in existence for several years, its value may be approximated by "adding to the interpolated terminal reserve (*i.e.*, cash surrender value) at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date (*i.e.*, the unexpired premium)." If the death of the insured is imminent, the value may be closer to face. *Estate of Pritchard v. Comm.,* 4 TC 204 (1944).

Where the grantor transfers property and retains a life estate, only the value of the remainder is a taxable gift. Similarly, if the donor retains an annuity for his life with another person receiving payments at his death, only the value of future interest is a taxable gift. The value of life estates, remainders, term interests and reversionary interests are determined by reference to actuarial tables in the treasury regulations.

XII. Time When Transfer Complete

Treas. Reg. §25.2511-2(b) provides that the effective date of transfer is that time when the donor relinquishes dominion and control over the transferred property. With respect to gifts of real estate, the transfer occurs when the deed is

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delivered to the grantee or, if the grantor files the deed, on the date when the deed is filed. A gift of stock is complete when an endorsed stock certificate is delivered to the donee or, if delivered to the donee's bank or broker, when title is transferred to the donee in the books of the corporation. The gift of a check is apparently not complete until the check clears. *Estate of Metzger v. Com'r*., 100 T.C. 204 (TC 1993), *aff'd* 38 F3d 1181 (4th Cir. 1994).

The transfer of property to a revocable trust is incomplete; however, to the extent funds are distributed to beneficiaries, a gift occurs at that time. The retention by the donor of significant powers with respect to property transferred to a trust – even an irrevocable trust – may result in an incomplete transfer for gift tax purposes. For example, the retention by the donor of a limited power to appoint new beneficiaries would result in an incomplete gift. Treas. Reg. §25.2511-2(c).

XIII. Valuation Discounts

Form 709, Page 2, Schedule A, line A, requires the donor to affirmatively state whether any item listed in Schedule A "reflects a valuation discount." The instructions (p.5) specify that any gift reflecting a discount for lack of marketability, a minority interest, or fractional interest, must be disclosed. For a gift to be adequately disclosed (and thus commence the three-year statute of limitations) the following information must be provided: (1) a description of the transferred property and any consideration received by the transferor; (2) the identity of, and the relationship between, the transferor and each transferee; (3) if the property is transferred in trust, the taxpayer identification number of the trust and a brief description of the terms of the trust, or in lieu of a brief description of the terms of the trust, a copy of the trust instrument; (4) a detailed description of the method used to determine the fair market value of the property transferred; and (5) a statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulation or revenue ruling published at the time of the transfer. Treas. Reg. §301.6501 (c)-1(e),(f). *Although not explicitly required, to satisfy the adequate disclosure requirement, a valuation discount appraisal may be necessary. Such an appraisal will satisfy requirement (4), above.*

Relevant discount studies should appear and be discussed in the expert's appraisal report. When determining the fair market value of real property, valuation discounts for (i) lack of marketability; (ii) minority interest; (iii) costs of partition; (iv) capital gains; and certain other discounts may be taken into consideration. Lack of marketability and minority discounts may be available for gifts of closely held stock. When transferring an interest in a closely held company, such as an LLC or FLP, the question arises whether one should obtain an appraisal even if the gift results in no current income tax liability. The problem with waiting until audit is that if a valuation error has occurred, a later appraisal will possess less probative value.

XIV. Assessment & Penalties

Generally, the IRS must assess a deficiency within the later of (i) three years of the date when the return is filed or (ii) the due date of the return, with extensions. IRC §6501(a). This period is tolled for 90 days if a notice of deficiency has been mailed. IRC §6503(a)(1). The period is six years if the taxpayer omits from the return more than 25 percent of the total gifts made during the period. However, a gift will not be considered omitted if such item is disclosed on the return or on a statement attached to the return. IRC §6501(e)(2). The statute of limitations for assessing a false or fraudulent return never expires. IRC §6501(c)(1). Similarly, if the taxpayer fails to file a gift tax return where one is due, the IRS may assess gift tax at any time. Tax assessed may be collected for a period of years following assessment. IRC §6502(a).

IRC §6701 imposes a penalty of $1,000 against any person who assists in the preparation of a return or other document where the person knows (or has reason to believe) that the use of such document would result in an understatement of tax liability of another person. The IRS may disqualify any appraiser against whom a penalty has been assessed. (Circular 230, §10.51(b)). Under IRC §6695A, a penalty may be imposed on an appraiser if he knew or should have known that the appraisal would be relied upon for tax purposes. The penalty is the greater of (i) 10 percent of the amount of tax attributable to the underpayment of tax attributable to the valuation misstatement, or (ii) $1,000, but in any case not more than (iii) 125 percent of the income received by the appraiser in connection with preparing the appraisal. The penalty will not apply if the appraiser establishes that the appraised value was "more likely than not" the correct value.

IRC §6651(a)(1) imposes a late filing penalty equal to 5 percent of the tax. This penalty is imposed each month with respect to which the taxpayer is delinquent, but may not exceed 25 percent. If the taxpayer can establish that the late filing is due to reasonable cause and not willful neglect, the penalty may be waived. Treas. Reg. §301.6651-1(c)(1). However, since the filing of a tax return is a nondelegable duty, reliance on an attorney to file an estate tax return was held not to constitute reasonable cause for abating the failure to pay penalty under IRC §6651. *Boyle v. U.S.*, 469 U.S. 241 (1985). Nevertheless, reliance on the advice of an attorney concerning when to file an estate tax return did establish reasonable cause. *Estate of Thomas v. Comm*., TC Memo 2001-225. The failure to file penalty increases to 15 percent per month, not to exceed 75 percent, if the failure to file is fraudulent. IRC §6651(f).

IRC §6651(a)(2) imposes a penalty of 0.5 percent per month for the failure to pay tax. The maximum penalty is 25 percent, which would accrue if the payment were 50 months late. The penalty will not apply if reasonable cause is established. Treas. Reg. §301.6651-1. Reasonable cause generally will be established if the taxpayer demonstrates the exercise of ordinary business care and prudence. Failing specific instructions, the IRS will apply partial payments in "descending order of priority until the payment is absorbed." *Within a given period*, payment will be applied, to tax, penalty and interest in that order until the payment is absorbed. Rev. Proc. 2002-26.

If a "valuation understatment" results in an underpayment of $5,000 or more, a penalty of 20 percent will be assessed with respect to the underpayment attributable to the valuation understatement. IRC §6662(g). The penalty increases to 40 percent if a "gross valuation understatement" occurs. The penalty will not apply if reasonable cause can be shown for the understatement. IRC §6664 (c)(2). A valuation understatement occurs when the value of property reported is 65 percent or less than the actual value of the property. A gross valuation understatement occurs if the reported value is 40 percent or less than the actual value of the property. IRC §6662(h).

An accuracy-related penalty is imposed on the portion of an underpayment attributable to negligence, which is defined as "any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code." The penalty imposed equals 20 percent of the underpayment. IRC §§6662, 6662(c).

IRC §7203, which addresses "omissions," provides that any person who "fails to make a return, keep any records, or supply any information, who willfully fails to pay such. . .tax, make such return, keep such records, or supply such information," shall be guilty of a misdemeanor, and subject to a fine of not more than $25,000 and

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LEGAL ISSUES INVOLVING GIFT TAX,

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imprisonment of not more than one year. IRC § 7201 provides that the willful attempt to "evade" any tax (including gift and estate tax) constitutes a felony, punishable by a fine of "not more than $100,000 ($500,000 in the case of a corporation)" and imprisonment of not more than 5 years, or both, together with costs of prosecution. IRC

XV Statutory Liens& Transferee Liability

Under IRC §6321, a lien arises in favor of the United States if any tax owed is not paid. The lien arises by operation of law, and attaches to all property, real and personal, owned by the taxpayer, including property acquired after the lien arises. Treas. Reg. §301.6321-1. IRC §6324(b) provides an additional lien for gift taxes. If the tax is not paid by the donor when due, the tax becomes a special lien on all gifts made during the period for which the return was filed. The lien continues for 10 years from the date gifts are made. The special gift tax lien is in addition to the general lien. Treas. Reg. §301.6324-1(d). If the donor fails to pay gift tax, the donee becomes personally liable for the tax. The donee's liability is limited to the value of the gift. IRC §6324(b);Treas. Reg. §301.6324-1.

XVI. Relationship to the Estate Tax

As noted, the amount of gift tax creditable for a particular year equals (i) the unified credit reduced by (ii) the credit claimed (or allowable) in prior years. (Form 709, Page 3, Schedule B, "Gifts From Prior Periods"; Page 1, Part 2, "Tax Computation," Lines 7 through 9.) The $1 million lifetime gift tax exclusion reduces, dollar-for-dollar, the applicable exclusion amount (AEA) available at death. Thus, if $1 million of gifts were made in 2008, the applicable exclusion amount available to the estate of a decedent dying in 2009 would be reduced from $3.5 million to $2.5 million. (The AEA will increase to $3.5 million on January 1, 2009.)

Under the "gross up" rule, all gift taxes paid with respect to any gifts made within three years of death will be included in decedent's gross estate. IRC §2035(b). The three year period commences on the date of the gift. If the donor were expected to live for more than three years (but not much longer), the donor might wish to prepay the gift tax on gifts of less than $1 million in order to remove the gift tax paid from his estate. Upon his death, his estate would receive a credit for the gift taxes paid. However, this strategy has been foreclosed, as there is no option to "prepay" the gift tax and defer taking the unified credit. This is evidenced by the preprinted figure of "$345,800" on Page 1, Line 7, of Form 709.

Illustration. Donor, who has made no previous lifetime gifts (other than annual exclusion gifts and gifts qualifying for the unlimited marital or charitable deduction) makes a gift of $5 million in cash in 2008 and lives for only two years after making the gift. The gift tax paid, which will have amounted to $1,680,000 (i.e., gift tax liability on $4 million taxable gift after $1 million lifetime exclusion), will be brought back into the decedent's estate — and will thereby attract estate tax — under IRC §2035(b). If the decedent had survived for more than three years after making the gift, the gift tax paid would no longer be included in the decedent's estate.

Under IRC §2035(a)(2), some transfers made within three years of death (in addition to any gift taxes paid thereon) will be brought back into the decedent's gross estate. To understand which gratuitous transfers made by the decedent during his life will be brought back into his gross estate under IRC §2035, one should first consider IRC §§ 2036, 2037, 2038 and 2042 separately. IRC §2036 operates to cause inclusion in the decedent's estate of any transferred interest over which the decedent possessed, at the time of his death, either (i) a right to income from the transferred property or (ii) the right to control beneficial enjoyment in the transferred property, at the time of death. IRC §2037 operates to include in the decedent's estate any transfer over which the decedent, at the time of his death, has retained a reversionary interest whose value, immediately prior to the decedent's death, exceeds five percent of the value of the property. IRC §2038 operates to cause inclusion in the decedent's estate transfers with respect to which the decedent retained until his death the power to alter (*e.g.*, change beneficiaries), amend, revoke or terminate. IRC §2042 operates to cause inclusion in the decedent's estate the value of insurance proceeds with respect to which the decedent has made a transfer within three years of death.

If the decedent possesses any of these aforementioned powers, interests or rights, the fair market value of the property at the decedent's death will be included in the decedent's gross estate by virtue of IRC §2036, IRC §2037, IRC §2038 or IRC §2042, operating independently. If the decedent releases any of those powers or interests before his death, **those provisions** would no longer operate to require inclusion in the decedent's gross estate of those interests. However, as will be seen, IRC §2035 could still require estate inclusion.

Illustration. Assume decedent in 2006 executed a deed in favor of his daughter, conveying title to Greenacre, but retaining a life estate. In 2007, decedent executed a quitclaim deed and forfeited his life estate in Greenacre. His daughter would then own a fee simple interest in the property. If the decedent died in 2006 **before** executing the quitclaim deed, the entire value of the property would be includible in his estate pursuant to IRC §2036 since decedent had retained a life estate. However, if decedent died **after** executing the quitclaim deed, IRC §2036 would no longer apply, since the decedent no longer had any interest in Greenacre at his death. This is where IRC §2035 becomes applicable.

IRC §2035 operates to cause inclusion under IRC §2036, §2037, §2038, or §2042, if the decedent made a transfer within three years of death which extinguished an interest that **would have** been included in the decedent's estate under either IRC §2036, 2037, 2038 or 2042 had the decedent not released the interest (within three years of death) which caused those provisions not to apply.

Illustration. In the previous example, if the decedent died in 2008 having executed the quitclaim deed in Greenacre in 2007, IRC §2035(a)(2) operates to cause inclusion of the entire value of Greenacre in the decedent's estate (at its fair market value at the decedent's death) since the decedent executed the quitclaim in Greenacre within three years of his death and the property would have been included in his estate under IRC §2036 **had he not** executed the quitclaim deed. IRC §2035(a)(2) essentially ignores the transfer of the retained life estate interest in Greenacre. Put another way, although the decedent did not possess any interest which would itself cause inclusion by virtue of IRC §2036 itself at the date of his death, IRC §2035(a)(2) operates to bring the value of the real estate back into the decedent's estate as though he had retained the life estate until his date of death.

The effect of IRC §2035(a)(2) is to increase the value of the property over which the decedent will eventually pay transfer tax, assuming the property appreciates between the date of the gift and the date of the decedent's death. In the event gifts with respect to which the decedent has paid gift taxes during his lifetime are included in his estate pursuant to IRC §2035(a)(2), the decedent's estate will receive credit for the gift taxes paid. This credit results from the procedure used to calculate the estate tax, which follows the same model as that used to calculate gift taxes where earlier gifts were made.The rule requiring inclusion under IRC §2035 for transfers made within three years of death will not apply to any "bona fide sale for an adequate and full consideration in money or money's worth." IRC §2035(d).

Interestingly, inclusion in the decedent's gross estate by virtue of the application of IRC §2035(a)(2) may not always be deleterious. If the property has appreciated significantly at the time of the initial gift, but not between the time of the gift and the time of the decedent's death, inclusion in the decedent's estate will result (i) no additional transfer taxes but will result in (ii) a step-up in basis at the decedent's death under IRC §1014 (b).

To avoid the three-year rule with respect to life insurance polices placed in an irrevocable life insurance trust (ILIT), the trustee may purchase the policy. This avoids the "transfer" which would cause inclusion under IRC §2035(a)(2). This technique will work well with a new life insurance policy. Although an

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FROM THE COURTS, CONT.

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was 'busy' does not tell us anything; it is just another conclusory statement." The Tribunal also noted that the investigator took no pictures of the actual business activity on the date of the investigation.

The Tribunal distinguished earlier cases which had sustained the use of "prior audit experience," explaining that "*this case does not reflect a change in that regard, but some evidence must be offered to show how that prior audit experience relates to the specific taxpayer." (Emphasis added).* In the cases cited by the Division, the auditor or investigator "had interaction with the owners or employees and made inquiries as to how the particular business was operated." The Tribunal noted that "[t]he *Oak Beach Inn* case was also distinguishable. Although the auditor relied, in part, on prior audit experience in that case, it involved a much more detailed record surrounding the test period and markup audit of that taxpayer." The audit record was sparse, and was based on the "very brief, conclusory statements of an investigator who did not testify and who could not be cross examined as to the manner of his 'investigation'."

Citing *Matter of Chartair,* 65 AD2d 44 (1978), and *Matter of Grecian Squire*, the Tribunal stated that unless the "audit experience" has "some relevance" to the taxpayer's business, "we have no way of knowing whether the audit experience relied on is valid or not. Thus, we conclude that the Division has failed to show a rational basis for its audit of petitioner's repairs, and that portion of the audit results must be cancelled."

This case demonstrates that although estimated methodologies need not result in "mathematical precision," and the burden remains on the taxpayer to show the lack of a rational basis, there is a limit to how far the Division can go when estimating sales. Here, the Division veered substantially over the line in estimating taxable repair sales. The demeanor of the Tax Appeals Tribunal panel and the tenor of their questions directed at the Division's counsel at oral argument left no doubt that the panel was clearly disturbed by the manner in which Petitioner's repair sales had been estimated. The decision, which has precedential value, sets a significantly higher standard for the Division when utilizing estimated methodologies.

[Although "Determinations" made by an ALJ following a hearing in the Division of Tax Appeals cannot be cited or relied upon in future administrative proceedings, "Decisions" of the the Tax Appeals Tribunal, in contrast, become part of the common law and, although they not as authoritative as cases decided by the Appellate Division, are *staré decisis* (lat.: to stand by that which was decided) and must be followed in later cases unless overturned.]

* * *

In another case decided this summer, the Tax Appeals Tribunal, finding the Division's estimated methodology for determining jewelry sales at a mall kiosk lacked a rational basis, also reversed the Determination of the ALJ, and cancelled the Notice of Determination. *Matter of the Petition of Muhammad S. Abbasi*, DTA No. 820239 (6/12/08).

[The taxpayer sold jewelry from a rented kiosk in the Broadway Mall in Hicksville. The Division commenced a sales tax audit based upon a complaint by a customer that the taxpayer had offered to charge no sales tax if the customer paid cash. Finding that the taxpayer had failed to produce requested books and records, the Divison's auditor resorted to an estimated methodology which computed sales tax liability by multiplying the rent by a factor of ten. On appeal, the Division asserted that rent factor employed was valid based upon the auditor's experience. The taxpayer argued that the audit methodology lacked a rational basis since the kiosk was not comparable to a jewelry store. The ALJ determined that the neither a bank deposit analysis nor an observation test was required even though those alternative methods might have produced a more accurate result. The instant appeal followed.]

The Tribunal found that resort to external indices was appropriate since the taxpayer had produced sufficient records. However, the Division's presentation of "an estimated dollar amount of sales . . . based on the Division's 'experience'," in which the "individual citizen has no opportunity to challenge or even examine" the audit methodology "strongly suggests the absence of fairness." The Tribunal held that the record "must contain sufficient evidence to enable the trier of fact to determine whether the audit has a rational basis." The ALJ justified its use of rent as a basis for projecting sales based upon Tax Law §1138(a)(1), which provides that "external indices" include items "such as . . . rental paid." However, the Tribunal found that the language "such as" followed by various specific examples "are clearly intended to be nonexclusive examples." The Tribunal "infer[red]" that "the estimate should be logically and empirically related to the subject of the tax."

The Tribunal then cited various cases where use of a rent factor was permitted. In those cases the "statistical report . . . was publicly available and the taxpayer would thus be able to challenge[] the soundness or applicability of the report." However, in *Matter of Basileo*, the Tribunal rejected an estimate of a restaurant's sales made by "obtaining figures for two other restaurants each deemed to be comparable . . . and averaging them." The Tribunal expressed skepticism with the Division's decision to use a rent factor of 10, based upon its claim that two recent "no change" audits for two other jewelry stores in Nassau County found gross sales in one to be 40 times the annual rent, while that in another audit, was 8 times the annual rent.

The Tribunal concluded:

"In each of the cases . . . in which rent-to-sales ratios have been found to provide a rational basis . . . the Division has begun with a broad sampling . . . and then tailored that information to make it comparable to the matter at hand. Although the logical and empirical connection between rental expense seems weak, in each case meaningful information was provided as to how the data underlying the rent factor was selected . . . and the petitioner was given a full opportunity to challenge [its] validity. Here, the auditor began and ended his analysis with 'a benchmark kind of thing' of ten times rent, which was apparently drawn from flea market audits and 'regularly used' in his office. The habits of mind so described do not in our view provide the required rational basis for estimating tax liability. Accordingly. . . the Notice of Determination is cancelled."

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