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ESTATE TAX MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
Shirlee Aminoff, Esq.

DATE: April 7, 2010

RE: Requirement of Filing Federal Gift Tax Return

A. Introduction

The requirement of filing a federal gift tax return arises when one has made a completed taxable gift. Incomplete gifts do not impose any gift tax filing requirement. Thus, the donor's gift of a diamond ring would exemplify a completed gift. However, if the donor reserved the power to revest beneficial title in the ring to himself at a later date, the gift would be incomplete. Many transfers in trust result in incomplete gifts. The donor who transfers property in trust with the direction to pay income to himself or to accumulate it in the discretion of the trustee, while retaining a testamentary power to appoint the remainder among his descendants, has made an incomplete gift. Treas. Reg. §25.2511-2.

The situation may arise where the taxpayer is unsure whether the gift is complete or incomplete. Treas. Reg. §301.6501(c)-1(f)(5) provides that adequate disclosure of a transfer that is

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reported as a completed gift will commence the running of the 3- year statute of limitations for assessment of gift tax, even if the transfer is ultimately determined to be an incomplete gift. However, in the converse situation, where a gift is reported as incomplete, but it is later determined to have been a completed gift, the result is less favorable: The period for assessing a gift tax will not commence to run until after a return has been filed reporting the completed gift.

Gifts qualifying for the annual exclusion, currently \$12,000, are neither reported nor taxed. Gifts qualifying for the annual exclusion must be gifts of a present interest. 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 date, will not qualify for the annual exclusion. Treas. Reg. §25.2503-3. Transfers in trust that would otherwise constitute future interests may be converted to gifts of a present interest by the inclusion of what are termed "Crummey" withdrawal rights.

Certain transfers, which might otherwise be considered gifts, are by definition excluded from those transfers which require filing a gift tax return. Thus, under IRC §2503(e), the gift tax does not apply to "qualified transfers" made directly to (i) political organizations; (ii) "qualifying domestic or foreign educational organizations as tuition"; or (iii) medical care providers for the benefit of the donee.

Gifts to spouses may or may not require the filing of a gift tax return. Gifts qualifying for the marital deduction do not require the filing of a gift tax return, unless a QTIP election is contemplated, in which case the return must be filed in order to make the election. The gift of a terminable interest to a spouse also requires the filing of a gift tax return. The gift of a life estate, an estate for a specified number of years, or any other property interest that will terminate or fail after a period of time, will constitute a nondeductible terminable interest for which a gift tax return must be filed. IRC §2523. Gifts to charities may require the filing of a gift tax return. If the donor's only gifts during the year were 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.

Some gifts which requiring reporting may not involve a situation where a "transfer" has

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occurred in its ordinary sense. Thus, even the exercise or release of a general power of appointment may constitute a taxable gift by the person releasing the power. IRC §2514(b). If a trust beneficiary releases a power to consume the principal of the trust, this would constitute a taxable gift. Unlike the filing rules relating to income tax returns, there is no provision for the filing of joint gift tax returns. However, 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. To report a split gift, one spouse would file a gift tax return on which the non-filing spouse formally consents to the splitting of the gift by signing the return. Generally, the decision to split gifts applies to all made during the year. Treas. Reg. §25.2513-1(b). 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 no gift tax is owed, a six month automatic extension sought for an filing 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 must be used. Form 709 requires a statement disclosing the adjusted basis of gifted property. No actual calculation of basis is required. Without a disclosure of basis, the return may not be accepted as filed by the IRS. 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.

B. Gifts Requiring Disclosure

If the value of any item reported as a gift reflects any valuation discount, Form 709 requires that an explanation be attached to the return. The instructions specify that any gift reflecting, among others, a discount for lack of marketability, a minority interest, or a fractional interest in real estate, must be disclosed. When claiming a discount, the taxpayer must offer evidence that the discount is

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appropriate. Mere reliance on previous cases where discounts were upheld is insufficient. Even if no gift tax is owed, the filing of Form 709 is crucial, as it commences the statute of limitations for revaluing the gift. 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.

For a gift to be adequately disclosed, the IRS must be apprised of the following information: (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 trust’s taxpayer identification number 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 regulations or revenue rulings published at the time of the transfer.

A typical disclosure statement, for the sale of an LLC interest to a “defective” grantor trust, might contain the following language: “The taxpayer sold 10 membership units in XYZ, LLC (the “LLC”) to the John Smith Irrevocable Trust dated June 15, 2006. The sales price was \$3 million. The following adjustment clause was included in the Purchase Agreement: ‘This transaction is intended to be an arm’s length transaction, free from donative intent. Accordingly, if, after the close of the transaction, the IRS determines that the fair market value of the membership units of the LLC is greater or less than the value determined by the appraisal used to establish the purchase price of the membership units, the purchase price will be adjusted to the fair market value as finally determined for Federal gift tax purposes by the IRS.’ A copy of the appraisal of the membership units in XYZ, LLC is attached hereto as Exhibit 1.”

With respect to item (4) above, the detailed description should include (a) financial data (e.g., balance sheets utilized in determining the value of any interest); (b) any restrictions on the transferred property that were considered in determining the fair market value of the property; and (c) a description of any discounts (e.g., minority or fractional interests; lack of marketability)

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claimed in valuing the property. The disclosure required by item (4) above may also be satisfied by an appraisal which meets the requirements of Treas. Reg. §301.6501(c)-1(f)(3). Such an appraisal must be prepared by an appraiser who satisfies all of the following requirements: (i) the appraiser is an expert who regularly performs appraisals; (ii) the appraiser possesses the expertise required to make appraisals of the type of property being valued; and (iii) the appraiser is not the donor or donee or a member of the family of the donor or donee.

The appraisal must contain the following information: (A) the date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal; (B) a description of the property; (C) a description of the appraisal process employed; (D) a description of the assumptions, hypothetical conditions, and any limiting conditions that affect the analyses, opinions and conclusions; (E) the information considered in determining the appraised value; (F) the appraisal procedures followed; (G) the valuation method utilized; and (H) the specific basis for the valuation, such as specific comparable sales or transactions.

In some cases a decedent has failed to file required gift tax returns during his lifetime. In such a case, the executor, in computing the estate tax, must include any gifts in excess of the annual exclusion made by the decedent, or on behalf of the decedent under a power of attorney. 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.

IRC Chapter 13 imposes a GST tax on all transfers, whether made directly or indirectly, to “skip” persons. Under IRC §2613(a), a skip person includes a person who is two or more generations below the generation of the transferor or a trust, if all of the interests are held by skip persons. Under IRC §2611(a), transfers subject to the GST tax are direct skips, taxable distributions, and taxable terminations.

IRC §2602 provides that the amount of the GST tax imposed on a transfer is determined by multiplying the amount transferred by the “applicable rate.” Under IRC §2641, the applicable rate is the maximum federal estate tax rate multiplied by the “inclusion ratio.” The inclusion ratio is one

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minus the “applicable fraction.” The applicable fraction is a formula designed to reflect the property that will be taxed under the GST tax rules. The GST tax exemption is the numerator of the fraction. Therefore, if more of the GST tax exemption is allocated to the transfer, the fraction will be greater, the inclusion ratio will be less, and the GST tax with respect to the transfer will be less.

IRC §2631 allows every transferor a GST exemption that may be allocated to transfers made by the transferor either during the transferor’s life or at death. Affirmative allocations of GST exemption are generally made on Form 709. Under IRC §2642(b)(1), if a transferor allocates GST exemption on a timely filed gift tax return, the transferor may allocate an amount of the GST exemption equal to the value of the property on the date of the transfer to reduce the inclusion ratio to zero.

Automatic allocations of GST exemption are made under IRC §2632 to certain transfers made during life that are direct skips, so that the inclusion ratio for such transfers may be reduced to zero even without any affirmative allocation of GST exemption.

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