Tax and Legal Issues Arising in Connection With The Preparation of the Federal Gift Tax Return, Form 709

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1. **Essential Elements of the Federal Gift Tax**.

a. **Property Law Requires Intent, Delivery and Acceptance.** The gift tax, which was enacted in 1932, is an excise tax imposed upon gratuitous transfers of "property"[1] during a calendar year. 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.[2] *W.H. Wemyss*, 324 U.S. 303. The Tax Reform Act of 1976 established a unified transfer tax system.

b. **Definition of "Taxable Gift".** The term "taxable gift" means the gross amount of gifts during the year, less (i) the annual exclusion of $12,000 per gift and (ii) any charitable or marital deductions[3] available. Gift tax liability (before application of the unified credit) for the calendar year 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.

i. **"Net Gifts".** If the donee is required, as a condition to receiving the gift, that he or she pay any gift tax associated with the gift, the gift tax paid by the donee may be deducted from the value of the transferred property to compute the donor's gift tax. The donee's payment of gift tax constitutes consideration paid for the gift. The amount of the gift depends upon the amount of gift tax

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[1] The holder of a general power of appointment possesses many of the benefits of outright ownership, since he may appoint the property to "himself, his creditors, his estate, or creditors of his estate." Thus, the *exercise* of a general power of appointment is the equivalent of a transfer of property, and may thus have gift tax consequences.

[2] *See, e.g.*, 4(a)(ii), *infra (creation of joint tenancy to avoid probate may lack donative intent).*

[3] The Tax Reform Act of 1981 removed the ceiling on the marital deduction.

payable. Yet the gift tax payable depends upon the amount of the gift. Since the two variable are dependent upon one another their calculation requires the use of simultaneous equations.

ii. **"Adjusted Taxable Gifts".** All post-1976 gifts are termed "adjusted taxable gifts," the total of which are added to the decedent's gross estate for purposes of determining the marginal tax rate applied to future gifts and ultimately to the taxable estate. However, transfers are not were taxed because for both gift and estate tax purposes, earlier gift taxes are credited in when determining current gift or estate tax liability.

iii. **Cumulative Nature of Gift Tax.** The marginal rate of tax imposed on a current year's gifts reflects aggregate taxable gifts for all periods. Therefore, the marginal rate of tax imposed on gifts made by a taxpayer who has made $500,000 in previous years' gifts, will be higher than the marginal rate imposed on a taxpayer who has made no previous gifts, even if each makes the amount of taxable gifts in the current year.

iv. **Some Gifts May Cause Taxable Gain.** The Supreme Court has held that the donor must report as gain the excess of the gift tax payable over the adjusted basis, reasoning that the gift tax payable is an "amount realized." *Diedrich v. Com'r.*, 50 AFTR 2d 82-5054. However, taxable gain would occur only when the property had appreciated to the extent that the gift tax exceeded adjusted basis.

v. **Gifts Excluded From Gross Income.** IRC §102 explicitly provides that gifts are excluded from the gross income of the donee. However, income from gifted property is taxable.

(1) **Source of Confusion to Some Taxpayers:** Persons unfamiliar with the tax laws are often under the mistaken belief that gifts cause taxable income to the donee.

vi. **Transfers for Inadequate Consideration.** If consideration – but less than the fair market value of the property transferred – is received by the donor in connection with the transfer, a sale or exchange has occurred, in addition to a gift. Treas. Reg. §25.2512-8. This necessitates payment of income, as well as gift, tax.

(1) **Exception for Transfers Made in Ordinary Course of Business.** Provided a transfer is made "in the ordinary course of business" (which is presumed to be at arm's length and lacking donative intent)

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no taxable gift occurs. Id.

c. **"Completed" Gifts Occasion Need to File Gift Tax Return.** Generally, the requirement of filing a federal gift tax return[4] arises when one has made a *completed* taxable gift.

i. **Exception.** 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[5]. IRC §6019.

ii. **Time When Gift is Complete.** 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 do not impose any gift tax filing requirement. Accordingly, a 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. No gift occurs because there is no assurance that any property will be left for the ultimate beneficiaries. However, a gift will not be incomplete merely because the donor reserves the power to change the manner or time of enjoyment.

iii. **Effect of Earlier Reporting Where Initial Transfer Redetermined.**

(1) **Return Filed Reporting Complete Gift.** Treas. Reg. §301.6501(c)-1(f)(5) provides the favorable rule 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.

(2) **Return Filed Reporting Incomplete Gift.** If a transfer is reported as an incomplete gift, and is later determined to have been a completed gift, the statute of limitations on assessment will not

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[4] New York abolished the gift tax as of January 1, 2000.

[5] Although IRC §6019 states that a gift tax is required to report gifts which qualify for the unlimited marital deduction, the regulations and the instructions to Form 709 provide that if the only gift made to a spouse is one which qualifies for the unlimited marital deduction is allowed for the entire interest, no return is required, unless the donor is reporting the transfer as one of a "qualified terminable interest" (QTIP). *See 3(a)(i), infra.*

commence until after a return is filed reporting the completed gift. This is true even if the initial return adequately disclosed the gift.

iv. **Signing by Agent.** 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, the donor must ratify the agent's statement within a reasonable time. Treas. Reg. §25.6019-1(h).

(1) **Example.** A General Power of Attorney may authorize the powerholder to make annual exclusion gifts, or may be drafted to allow even larger gifts for purposes of estate planning. However, courts may scrutinize large gifts made under powers of attorney since in effect such gifts could defeat the donor's testamentary intent as expressed in his will.

v. **Amended Returns.** 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, or for the Commissioner's acceptance, 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. *See* Treas. Reg. §25.2504-1(d). Filing an amended return does not cure fraud on an original return. *Badaracco v. Com'r*., 464 U.S. 386 (1984).

vi. **Executor's Responsibility.** 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.

d. **Importance of Basis.** Gifts are valued as of the date of the gift. IRC §2512. 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 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.

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i. **Basis of Property Acquired by Gift.** The basis of property acquired by gift is the same as the basis in the hands of the donor, with one exception: If the fair market value of the property is less than the donor's basis, then for purposes of determining the donee's loss on a later sale, the basis is limited to fair market value. For example, if the fair market value of property gifted equals $5,000 and its adjusted basis in the hands of the donor equals $10,000, then the donee's basis for purposes of determining loss on a later sale is $5,000. For purposes of determining the donee's later gain, the donee may use the higher transferred basis. IRC §1015(a); §1016; Treas. Reg. §1.1015(a)(1).

(1) **Review of Rules Where FMV on Date of Gift Less than Adjusted Basis.**

(a) **For Purposes of Determining Donee's Gain on Later Sale.** Use donor's transferred basis.

(b) **For Purposes of Determining Donee's Loss on Later Sale.** Use FMV at date of gift.

(c) **Effect:** If Donee sells property in above example for between $5,000 and $10,000, no gain or loss is recognized. No gain is recognized because for purposes of determining gain, the donee's adjusted basis is $10,000. No loss is recognized, because the donee's adjusted basis is limited to $5,000 for purposes of calculating loss.

(2) **Basis Unknown.** If the basis is unknown, the IRS may determine basis from available facts. If impossible, the IRS may utilize the fair market value as of the date the property was acquired by the donor or the last preceding owner. IRC §1015(a); Treas. Reg. §1.1015-1. To ensure proper determination of basis, donors and donees should preserve adequate records to determine the cost of the property and its fair market value as of the date of the gift. Treas. Reg. §1.1015-1(g).

(3) **Determining Basis of Gifts of Life Estate.** 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).

ii. **Donee May Increase Basis by Portion of Gift Tax Paid by Donor.** A fraction of the gift tax paid by the donor will operate to increase the basis of the transferred property in the hands of the donee. (IRS Pub. 551). That fraction can be expressed mathematically as follows:

(1) **Appreciation From Acquisition to Date of Gift**
FMV of Property at Date of Gift

(a) **Illustration**. Donor's Basis in Property is $100,000. Donor 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). 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.

iii. **Certain Bequests Made Within One Year of Death.** 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. **Donor Dies Early in Current Year.** Normally, Form 709 is required to be filed by April 15th unless an extension is requested. However, if the donor dies early in the current year, 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.

e. **Preparer Penalties.** 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 the preparer (or advisor) 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 that the position has a one-in-three chance of success. P.L.

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110-28, §8246(a)(2), 110th Cong., 1st Sess. (5/25/07). The 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 the tax return preparer with respect to the return. An attorney who gives 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.

i. **Circular 230 "Deputizes" Attorneys and Accountants.** Revised IRC §6694 joins Circular 230, now two years old (which Roy M. Adams, Esq., observed effectively "deputizes" attorneys, accountants, financial planners, trust professionals and insurance professionals) in "extend[ing] the government's reach and help[ing to] fulfill a perceived need to patch up the crumbling voluntary reporting tax system." The Changing Face of Compliance, *Trusts & Estates*, Vol. 147 No. 1, January 2008. The perilous regulatory environment in which attorneys and accountants now find themselves counsels caution when advising clients concerning tax positions. Although a taxpayer's right to manage his affairs so as to minimize tax liabilities is well-settled, Congress has signified its intention to hold tax advisers to a higher standard when rendering tax advice.

ii. **Notice 2008-13.** Notice 2008-13 contains guidance concerning the imposition of return preparer penalties. It provides that until the revised regs (expected to be issued before the end of 2008) are issued, a preparer can generally continue to rely on taxpayer and third party representations in preparing a return, unless he has reason to know they are wrong. In addition, preparers of many information returns will not be subject to the IRC §6694 penalty unless they willfully understate tax or act in reckless or intentional disregard of the tax law.

f. **Gifts "Finally Determined" Cannot Be Revalued.** 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.

i. **Caution: IRS May Revalue For Purposes of Increasing Marginal Rate on Later Gifts.** 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 will not result in additional tax liability with respect to the initial gift, the marginal tax rate imposed on later gifts could be higher.

ii. **Sometimes Prudent to File Gift Tax Return Even When No Gift.** Sales of assets (*e.g.*, membership interests in family limited partnerships) to grantor trusts should result in no gift and no gift tax. However, if the IRS mounts a successful challenge to the valuation discount taken, the promissory note paid for the membership interest will have been less than the (revised) fair market value of the membership interest sold to the trust. In this case, the IRS could assert that the excess constitutes a taxable gift. To cause the statute of limitations to commence in this situation, some practitioners believe that a gift tax return should be filed reporting no gift but including documentation regarding the transaction and the valuation discount taken. By doing so, it has been posited that after three years has elapsed, the IRS may be unable to challenge the value of the membership interest sold to the trust. *See also* Treas. Reg. §25.2504-2(c).

g. **Annual Exclusion Gifts.** Gifts qualifying for the annual exclusion, currently $12,000, are neither reported nor taxed. 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.)

i. **Source of Confusion:** Persons unfamiliar with the tax law sometimes believe that gifts in excess of the annual exclusion result in immediate tax liability, and do not realize that taxpayers may actually give up to $1 million before any actual current gift tax liability arises.

ii. **Present Interest Requirement.** Annual exclusion 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.

iii. **Must Have Present Possessory Interest.** In *Hackl v. Com'r.*, 2003-2 USTC ¶60,465, 335 F3d 664 (7th Cir. 2003, *aff'g* 118 TC 279) the transfer of LLC membership interests by parents to children did not qualify for the annual gift tax exclusion since the children did not possess the unrestricted right to the immediate use, possession or enjoyment of the LLC membership

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interests or the income therefrom. To qualify for the annual exclusion, the children were required to receive a "substantial present economic benefit" in the membership units, rather than merely legal rights in the transferred property.

iv. **Special Rule for Trusts for Minors.** IRC §2503(c) permits the creation of certain trusts for minors which do not satisfy the present interest requirement, but which will nevertheless qualify for the annual exclusion. The dispositive provisions of such "2503(c)" trusts, must provide that (i) until the beneficiary reaches the age of 21, the trustee may pay the income and/or the underlying assets to the beneficiary; and (ii) any income and assets not paid to the beneficiary prior to age 21 will be paid when the beneficiary reaches age 21.

v. **"Crummey" Trusts.** Other 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 annual "Crummey" withdrawal rights. The trust can be created for a beneficiary of any age, and can terminate at any age the donor specifies. Accordingly, the "Crummey" trust is much more flexible than the Section 2503 minor's trust. However, for this technique to work, there must be no prior understanding that the funds will not be withdrawn. *Estate of Kohlsaat*, TC Memo. 1997-212.

h. **Summary of Computation of Gift Tax Payable.**

i. **Step One: Determine Gift Tax Liability.** The donor's current gift tax liability equals the difference between (i) the gift tax liability calculated at current rates for the donor's cumulative taxable gifts (*i.e.,* current and previous years' gifts) and (ii) the gift tax liability calculated at current rates for the donor's cumulative adjusted taxable gifts made through the end of the preceding period (*i.e.,* previous years' taxable gifts). (Form 709, Page 1, Part 2 "Tax Computation," Lines 4 through 6.)

ii. **Step Two: Determine and Apply Available Unified Credit.** The current unified credit is $345,800. This credit will absorb the gift tax of $345,800 imposed on $1 million in taxable gifts at current gift tax rates.[6] The amount of the *available* unified credit in a given taxable year is $345,000 reduced by

[6] Assuming no previous taxable gifts.

the aggregate amount of the unified credit utilized (or available)[7] in other periods. (Form 709, Page 1, Part 2 "Tax Computation," Line 9.)

iii. **Illustration.** Donor, who had made no previous taxable gifts, made gifts of $100,000 in 2006 and 2007. Donor filed a 2007 gift tax return reporting the gift of $100,000 made in 2006 as well as the gift tax liability of $23,800 for that gift. (Instructions, p. 12, "Table for Computing Gift Tax"). Donor's unified credit of $345,800 was reduced by $23,800, to $322,000. In 2008, donor reported a current gift tax liability was $31,000, 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 the donor's cumulative adjusted taxable gifts for all previous periods). Since the donor had a gift tax liability of $31,000 and an available unified credit of $322,000, the donor's available unified credit going into 2009 will be $291,000.

i. **Operation of Unified Credit.** The unified credit of $345,800 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. Gift tax liability will arise once the donor's lifetime gifts exceed $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 7.)

i. **Marginal Rate of Gift Tax once Gift Tax Liability Arises.** 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 is credited out by the unified credit of $345,800.) The maximum gift tax rate in 2008 is 45 percent. (Instructions, p. 12, "Table for Computing Gift Tax".)

ii. **Marginal Rate Scheduled to Decrease, then Increase.** The highest marginal gift tax rate is scheduled to decrease to 35 percent[8] in 2010. In 2011, when EGTRRA "sunsets," the highest gift tax rate is scheduled to return to 55 percent.

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[7] If no gift tax return was filed for a taxable gift made in a previous taxable year, the amount of unified credit that could have been claimed will reduce the available unified credit in the current year.

[8] The highest gift tax rate will actually equal the highest personal individual income tax rate in 2011. Therefore, if that rate changes, so too will the highest gift tax rate.

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iii. **Unified Credit Indicated on Form 709.** Page 1, Part 2, Line 7 of Form 709 indicates $345,800 as the maximum unified credit. This amount will offset $1,000,000 of taxable gifts.

iv. **Donor May Not "Prepay" Gift Tax.** There is no option to prepay the gift tax, defer taking the unified credit, and credit the estate tax liability with the gift taxes earlier paid. Although rarely would one want to prepay the gift tax, it is conceivable that one might wish to prepay the gift tax to remove the gift tax paid from the decedent's estate. However, this strategy has been foreclosed, as evidenced by the preprinted figure of $345,800 on Form 709.

v. **Date of Gift Indicated on Return.** 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.

vi. **Amount Creditable.** The amount 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.)

vii. **Gift Tax Lifetime Exclusion "Counts" Toward Applicable Exclusion Amount.** The $1 million lifetime gift tax exclusion reduces, dollar-for-dollar, the applicable exclusion amount available at death. Thus, if $1 million of gifts were made in 2008, the applicable exclusion amount available to the estate of a decedent in 2009 would be reduced from $3.5 million to $2.5 million.[9]

j. **Extensions of Time to File and Pay**. 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.

i. **Payment Must be Made Regardless of Extension.** The grant of an extension for filing a return does not operate to extend the time for payment.

ii. **Regulatory Extensions.** Extension of time periods provided by regulation,

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[9] The applicable exclusion amount will increase to $3.5 million on January 1, 2009.

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 extensions of statutory deadlines cannot be made.

iii. **Extensions of Time to Pay.** 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.

(1) **Applications for Extension of Time to Pay.** 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. Treas. Reg. §25.6161-1 provides that the term "undue hardship" connotes more than inconvenience to the taxpayer, and comprehends a situation where the taxpayer will suffer a substantial financial loss.

k. **Split Gifts Between 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. The effect is to double the available annual exclusion gifts and to reduce the marginal gift tax rate. Also, each spouse's unified credit may be tapped. (Form 709, Page 2, Schedule A, "Computation of Taxable Gifts, Part 1, Column G.)

i. **Formal Requirements.** 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.

ii. **Reporting a Split Gift.** To report a split gift where only one spouse has made a transfer requiring a gift tax return, the spouse making the gift would

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be 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.

(1) **Where Both Spouses Make Gifts During Year.** 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.

iii. **Consent Applies to All Gifts Made During Year.** 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).

iv. **Time for Consenting to Split Gifts.** 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).

v. **Taxable Gifts Reduced.** By consenting to split gifts, each spouse's gift is reduced by half.[10] (Form 709, Page 2, Schedule A, "Computation of Taxable

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[10] Gifts by one spouse to another spouse cannot be split.

Gifts, Part 1, Column G.)

vi. **Liability Occasioned by Splitting Gifts.** 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. For example, if one spouse consents to split the gift of a life insurance policy owned by another spouse, and the other spouse dies within three years, the entire value of the policy will not be included in the estate of the consenting spouse. *See* Rev. Rul. 54-246.

l. **Gifts by Nonresidents.** 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).

i. **Gifts of Tangible vs. Intangible Property.** 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. Accordingly, the gift of a diamond ring by a nonresident would be subject to the gift tax. However, if the nonresident tendered a check to the intended donee and the donee herself purchased the diamond ring, no gift tax liability would arise. In any case, the nonresident alien can exclude by virtue of the annual exclusion, up to $12,000 of each taxable gift.

ii. **Credit for Foreign Gift Taxes Paid.** 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 the United States has a convention in effect: Australia, Austria, Denmark, France, Germany, Japan, Sweden and the United Kingdom. The donor must attach evidence indicating payment of foreign taxes. The amount of the credit is determined by the applicable convention. (Form 709, Page 1, Part 2, line 13).

2. **Transfers Excluded by Congress**. Certain transfers, which would otherwise constitute taxable gifts, have been excluded by Congress from the definition of a transfer 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

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to (i) political organizations; (ii) "qualifying domestic or foreign educational organizations as tuition"; or to (iii) to medical care providers for the benefit of the donee. Again, these gifts "should not" (according to the gift tax instructions) be reported any Form 709. (Instructions, p. 2.)

a. Donor "Should Not" Report Excluded Transfers. For filing purposes, exempt transfers are like charitable gifts in the sense that they are not reported when no gift tax return is otherwise required to be filed by the donor. Unlike charitable gifts, these transfers are also not reported even when the donor is required to file a gift tax return reporting other transfers. The instructions (p. 2) provide that excluded transfers "should not" be reported on any Form 709.

b. Transfers to Political Organizations. Transfers to political organizations defined in IRC §527(e)(1) should not be reported on any gift tax return. A political organization, as so defined, consists of a "party, committee, association, fund, or other organization . . . organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function."

c. Transfers to Educational Institutions. The gift tax does not apply to payments made **directly** to a domestic or foreign educational institution (maintaining a regular faculty, curriculum and campus) as tuition for any person (no relationship requirement). (*See* IRC §170(b)(1)(A)(ii)). The exclusion **does not apply** to amounts paid (even directly) for books, supplies, room and board, or other "similar" expenses not constituting tuition.

d. Transfers to Medical Care Providers. Transfers made **directly** to persons (*e.g.,* doctors) or institutions that provide medical care (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). Medical care also includes insurance (to the extent not reimbursed).

e. Transfers Incident to Divorce.

i. No Gift Tax Consequences if Transfer Pursuant to Written Agreement in Context of Divorce. In some instances, 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 former spouses if the transfer is incident to divorce, 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.

ii. **No Income Tax Consequences under IRC §1041 if Transfer Incident to Divorce.** IRC §1041(a) provides that no gain or loss shall be recognized on the transfer of property between spouses, or former spouses if the transfer is incident to divorce. IRC §1041(b) further provides that the property will be deemed to have been acquired by gift, and that the donee will take a substituted basis in the property.

f. **Qualified Disclaimers.** 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. 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 (i) the spouse of the decedent or (ii) 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.

3. **Marital and Charitable Gifts.**

a. **Unlimited Deduction for Outright Gifts to Spouses.** 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 4, "Taxable Gift Reconciliation," Lines 4 and 5. With one exception, gifts of terminable interests in which the donee-spouse's interest (in a narrow sense) will fail or terminate at some future time, will not qualify for the unlimited marital deduction. The single exception relates to qualifying "QTIP" transfers. QTIP transfers are deductible in full.

i. **Filing Requirement.** There is no independent requirement for filing a gift tax return to report a spousal gift which qualifies for the unlimited marital deduction. (Instructions, p. 2.) However, if a return is filed reporting other gifts, all marital gifts must be reported, even those which qualify for the unlimited marital deduction.

ii. **Gifts to Nonresident Spouse.** 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).

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iii. **Gifts of Nondeductible Terminable Interests.** As noted, gifts to a spouse of a terminable interest consisting of the gift of a life estate, an estate for a term of years, or any other property interest that will terminate or fail after a period of time, also require the filing of a gift tax return, and are not deductible.

(1) **Filing Requirement.** A return is required to report the gift of a nondeductible terminable interest. (Instructions, p. 2.)

(2) **Distinguish: Some Terminable Interests Are Deductible.** Not all gifts of terminable interests are not deductible. Nondeductible terminable interests, thought of in a narrow sense, are gifts to a spouse consisting of some present interest, but which will later fail or terminate because the interest shifts to another person at some future time. However, some terminable interests given to a spouse will fail or terminate, but not because possession will shift to another person. Thus, gifts consisting of a terminable interest which terminates or fails not because the spouse's interest shifts to another person, but rather by the very nature of the property, are fully deductible. One example of such an interest is a patent, which becomes worthless after the passage of a certain amount of time. The gift to a spouse of a patent will fail or terminate when the patent becomes worthless. Nevertheless, the gift would be fully deductible assuming the spouse is given the entire interest in the patent.

iv. **Gift of Life Estate with Power of Appointment.** Provided the following four conditions are satisfied, the gift of a life estate with a power of appointment will qualify for the marital deduction and is not required to be reported on a gift tax return: (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.

(1) **Filing Requirement.** A return is required to report the gift of a life estate with power of appointment.

(2) **Inclusion in Estate of Donee-Spouse.** Property remaining in the 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.

(a) **Basis step up.** 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).

v. **QTIP Exception to Nondeductible Terminable Interest Gifts.** Certain "terminable interests" which would not otherwise qualify as a life estate with power of appointment because they do not satisfy requirement (iii) above, may nevertheless be deductible. In 1982, Congress enacted a rule which permits a deduction for "qualified terminable interest property." Accordingly, 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. The QTIP election is also available with respect to the estate tax.

(1) **Rights Which Must be Accorded to Spouse.** To effectuate a valid QTIP transfer, the donee spouse must possess a "qualifying income interest for life." This requirement will be satisfied if (i) the spouse is entitled to all of the income from the property during her life, paid no less frequently than annually and (ii) no person has the power to appoint any of the property to any other person during the life of the donee-spouse.

(2) **Electing QTIP Treatment.** To claim the QTIP deduction, an 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.)

(3) **Electing Not to Claim QTIP Treatment.** If the donor wanted to make a spousal gift which would otherwise qualify for QTIP treatment, but QTIP treatment is not desirable, perhaps because the estate of the donee spouse is large, then the donor would simply not deduct the value of the QTIP property on the gift tax return on Form 709, Page 3, Part 4, Line 4.

(4) **Value of Property Included in Donee-Spouse's Estate.** Although

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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 date of death of the surviving spouse.

(5) **Donee Must Include Entire Corpus of Trust.** The entire value of the trust must be included in the estate of the donee spouse at his death, not merely the value of the life estate.

(6) **Estate of Donee-Spouse Receives Basis Step-Up.** The basis of the property will be stepped up to fair market value at the date of death of the donee-spouse by reason of its inclusion in the estate of the donee spouse. IRC §1014(b)(10).

vi. **Review of Filing Requirements for Spousal Gifts.** The gift to a spouse for which a marital deduction is available under IRC §2523(a) does not in itself generate a filing requirement. Gifts of a "terminable interest" for which a QTIP deduction is allowed does require the filing of a gift tax return, whether nor not QTIP treatment is elected (by virtue of claiming a deduction on Form 709). Furthermore, if filing is required to file by reason of a QTIP transfer, all marital gifts made during the calendar year must be reported.

vii. **Estate Planning Advantages of Lifetime Gifts to Spouses.** 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.

b. **Deduction for Gifts to Charities.** 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.

i. **Entities to Which Gifts Are Deductible.** 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.

(1) **Foreign Charitable 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.

ii. **Compare: Income Tax Deduction.** 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.

iii. **Reporting Requirements.** Gifts to charities may or may not require reporting. 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. In that case, the charitable gift would be reported along with a corresponding deduction. (Instructions, p. 2.)

iv. **Split-Interest Gifts.** Special rules apply to split-interest transfers. Gifts of remainder interests to charitable organizations are deductible only if the remainder interest is in a personal residence, a farm, or a charitable remainder annuity trust or unitrust. A split-interest gift of a present interest to a charity qualifies for a deduction only if the charity receives a guaranteed annuity interest or a unitrust interest.

4. **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).

a. **Creation of Joint Tenancies.**

i. **Creation of Joint Bank Accounts.** 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. (*See* Rev. Rul. 55-278, taxable gift occurs where co-owner's name removed from U.S. savings bond.) The rationale for this rule is that the donor can reacquire the funds until withdrawn by the other joint owner.

ii. **Creation of Other Joint Tenancies.** 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 has occurred when the joint tenancy was created. Treas. Reg. §25.2511-1(h)(4).

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(There is some authority for the proposition that if creation of the joint tenancy in real estate were effected for purposes of avoiding probate, donative intent would be lacking, and therefore no gift would have occurred.) In practice, it appears that few taxpayers file gift tax returns when a joint tenancy in real estate is created, although this practice is questionable as a matter of tax compliance. 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).

(1) Joint Tenancy Between Spouses. No gift tax will arise by 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.

(a) Tenancy by the Entirety is Default Method of Holding Title Between Spouses. 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 between a tenancy by the entirety on the one hand, and a joint tenancy or tenancy in common on the other, 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.

b. Assignment of Benefits in Life Insurance Policy. 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. The instructions (p. 8) state that the name of the insurer and policy number should be listed on the gift tax return.

i. Retained Right to Change Beneficiaries. In contrast to the situation where the owner makes an irrevocable transfer of policy benefits to a

beneficiary, if the owner retains the right to change beneficiaries, the transfer is incomplete.

c. **Gifts to Partnerships & Minors.** 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). A gift to a minor in trust is considered a gift of a present interest if (i) both the property and its income may be expended for the benefit of the minor before age 21; (ii) all remaining property and income must pass to the minor on the minor's 21st birthday; and (iii) if the minor dies before age 21, the property and its income will be payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

d. **Below Market Loans.** Under IRC §7872, the transfer of money without the provision for 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.[11] Under a *de minimus* rule, no gift or income tax consequences result if the loan (or loans to one person) does not exceed $10,000.

e. **Exercise or Release of a General Power of Appointment.** The exercise or release of a general power of appointment may also constitute a taxable gift 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 exercise or release of a limited power of appointment could also result in a completed transfer for gift tax purposes if by relinquishing the limited power the donor completes a previous transfer. However, the mere retention of a limited power will not result in a taxable transfer since the "bundle of rights" which elevates a general power of appointment to the status of "property" in the context of the general power of appointment does not exist in the context of a limited power of appointment. If the donor relinquishes a limited power of appointment, but retains another limited power of appointment or other significant right or interest, the relinquishment of the limited power will also not result in a taxable gift.

5. **Determining Value of Gift.** Gifts are valued at the time transfer is complete. Treas. Reg. §25.2512-1 provides that the fair market value of property for gift tax purposes is "the

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[11] For income tax purposes, the foregone interest is treated as being retransferred from the borrower to the lender. The amount of the foregone interest is calculated in the same manner as it is for gift tax purposes. Although the lender is required to report interest income, the borrower may or may not receive a corresponding deduction, depending upon whether any of the rules limiting the deductibility of interest applies.

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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." The buyer and seller are hypothetical and what an actual willing buyer or seller would pay has been held to be irrelevant. *U.S. v. Simmons*, 346 F.2d 213, 217 (5th Cir. 1965). Reasonable knowledge of the facts includes facts that could be discovered with reasonable investigation. *Estate of Baldwin v. Comm.*, 18 TCM (CCH) 902 (1959).

a. Valuing Real Property. 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.

b. Valuing Stocks. 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 reference their market value and should include the CUSIP (Committee on Uniform Identification Procedure). Valuation services provide historical information for a fee. Historical stock quotes are also available on the internet. If no sales on the valuation date exist, 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. Treas. Reg. §20.2031-2(e) provides that a blockage discount may be applied where a large block of stock may depress the sales price. Conversely, the gift of a controlling interest of stock would require an upward valuation. Treas. Reg. §25.2512-2(e).

i. Valuing Closely Held Stocks. Closely held stocks should be valued by an appraiser, and should include the EIN. Fair market value of closely held stock 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."

ii. Rev. Rul. 59-60. Rev. Rul. 59-60, an often-cited ruling, sets forth a list of factors to be considered when valuing closely held businesses: (i) the

nature of the business and the history of the enterprise; (ii) the economic outlook in general and the condition and outlook of the specific industry in particular; (iii) the book value of the stocks and the financial condition of the business; (iv) the earning capacity of the company; (v) the dividend-paying capacity of the company; (vi) goodwill and other intangible value; (vii) sales of stock and the size of the block of stock to be valued; (viii) the market price of stocks of a corporation engaged in the same or a similar line of business having their stocks actively traded in a free open market, either on an exchange or otherwise.

c. **Valuing Artwork.** 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 (provinence) of the artwork will greatly affect its gift tax value. As is the case with large blocks of stock, if large blocks of artwork are gifted, a blockage discount may apply. *Calder v. Comm.*, 85 TC 713 (1985). The IRS does not recognize fractional interest discounts in the context of artwork, since the IRS 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 2007-2292 (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.)

i. **Art Advisory Panel.** The Art Advisory Panel is comprised of a collection of unpaid art experts. The panel reviews audited returns on which an item of art is valued at $20,000 or more, or returns in which the IRS believes that the fair market value exceeds $20,000.

ii. **Rev. Proc. 96-15.** Under Rev. Proc. 96-15, prior to filing the gift tax return, the taxpayer may apply to the IRS for a "statement of value" for gift tax purposes. Under the procedure, a qualified appraisal is attached to the request (in addition to a user fee of $2,500).

d. **Valuing Automobiles.** Treas. Reg. §25.2512-1 provides that the value of an automobile for gift tax purposes is the price at which a similar automobile could be purchased by the general public, and not the price at which the automobile could be purchased by the donor from a dealer. Treas. Reg. §25.2512-1 provides that the fair market value of an item should be determined by considering the market in which it is typically sold to the public.

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e. **Valuing Life Insurance Contract.** 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, the value of the gift may not be readily ascertainable. In that case, it can 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). The regulations provide several examples. If the death of the insured is imminent, standard valuation methods may not be accurate, as the value may be closer to face. *Estate of Pritchard v. Comm.,* 4 TC 204 (1944).

f. **Valuing Life Estates and Remainder Interests.** 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. Finally, if the grantor transfers property in trust with income to another person for a term of years, retaining a reversionary interest, the portion of the transfer comprising the value of the term of years 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.

i. **Factor for Life Estates or Term Interests.** The factor for life estates or term interests is 1 minus the remainder factor.

ii. **Factor for annuity.** The factor for an annuity is the life estate or term factor divided by the IRC §7520 rate. The Section 7520 rate, revised monthly, is 120 percent of the midterm Applicable Federal Rate (AFR) for the month of the transfer.

g. **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.

i. **Real Estate.** With respect to gifts of **real estate**, the transfer occurs when the deed is delivered to the grantee or, if the grantor files the deed, on the date when the deed is filed.

ii. **Stock.** 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).

iii. **Revocable Trusts.** The transfer of property to a revocable trust is incomplete; no gift occurs. However, to the extent funds are distributed to beneficiaries, a gift occurs at that time.

iv. **Retained Powers.** 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 gift. 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).

v. **Reciprocal Trust Doctrine.** Under the reciprocal trust doctrine, where two persons make annual exclusion gifts to their own children as well as to the children of siblings, the number of annual exclusion gifts will be limited to the gifts made to the parents' own children. *Estate of Schuler v. Com'r.*, 282 F3d 575 (8th Cir. 2002). So too, one cannot increase the number of annual exclusion gifts to family members by the expedient of engaging intermediaries. *Heyen v. U.S.*, 945 F2d 359 (10th Cir. 1991).

6. **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, among other discounts, a valuation discount for lack of marketability, a minority interest, or fractional interest, must be disclosed. When claiming a discount, the taxpayer must offer evidence that the discount is appropriate. Mere reliance on previous cases where discounts were upheld would appear to be insufficient.

a. **Information Required for Adequate Disclosure.** For a gift to be adequately disclosed, and thus commence the three-year statute of limitations, the IRS must be provided with 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 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).

b. **"Adequate Disclosure" May Necessitate Appraisal.** Although not explicitly required, to satisfy the "adequate disclosure" requirement, an appraisal may be necessary. A real estate appraiser may use one of three valuation methods: (i)

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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 relatively 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. Relevant discount studies should appear and be discussed in the expert's appraisal report.

c. **Valuation Discounts for Real Property.** 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.

d. **Valuation Discounts for Closely Held Stock.** Lack of marketability and minority discounts may be available for gifts of closely held stock.

e. **When to Obtain Expert Appraisal.** When transferring an interest in a closely held company, such as an LLC or FLP, the question arises whether one should obtain an appraisal if no taxable gift will occur. One problem with waiting until audit is that if a valuation error has occurred, a later appraisal with a higher value will possess less probative value.

f. **Appraiser Penalties.** IRC §6701 imposes a penalty of $1,000 against any person who assists in the preparation of a return or other document relating to a person (other than a corporation) who knows (or has reason to believe) that such document or portion will be used, and that its use 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)). The Pension Protection Act of 2006 added new appraiser penalties. 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 10 percent of the amount of tax attributable to the underpayment of tax attributable to the valuation misstatement, or $1,000, but in any case not more than 125 percent of the income received by the appraiser in connection with preparing the appraisal. The penalty can be avoided if the appraiser establishes that the appraisal value was "more likely than not" the correct value.

7. Penalties & Interest.

a. **Late Filing Penalty.** 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.

b. **Fraudulent Failure to File.** 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).

c. **Failure to Pay Tax.** 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.

i. **Taxpayer May Direct Application of Payment.** If the IRS assesses tax, penalties and interest, the taxpayer making a partial payment may specifically direct how the funds are to be applied. Failing specific instructions, the IRS will apply the payment to "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.

d. **Valuation Understatement Penalties.** 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).

e. **Accuracy-Related (Negligence) Penalty.** 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).

f. **Criminal Tax Omission Penalty.** 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

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records, or supply such information," shall be guilty of a misdemeanor, and subject to a fine of not more than $25,000 and imprisonment of not more than one year.

g. **Criminal Tax Evasion Penalty**. 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 §7201.

h. **Interest.** 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). However, estimated payments of gift tax are not required.

i. **Time Period for IRS to Assess.** 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.

j. **Time Period for IRS to Collect.** Tax assessed may be collected for a period of 10 years following assessment. IRC §6502(a).

8. Statutory Liens & Transferee Liability.

a. **General Lien.** 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.

b. **Special Gift Tax Lien.** 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).

i. **Transferee Liability.** 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.

ii. **Time Period for Making Assessment Against Transferee.** An assessment may be made against the transferee (donee) for up to one year following the expiration of the period of limitations for assessment against the transferor (donor). IRC §6901(c)(1).

(1) **Initial Transferee Makes Transfer to Subsequent Transferee.** Where the initial transferee makes a transfer to a subsequent transferee, the period for assessment ends on the earlier of the date which is (i) three years after the expiration of the period of limitations for assessment against the taxpayer (donor) or (ii) one year after the expiration of the period of limitations for assessment against the preceding transferee. Treas. Reg. §301.6901-1(c)(2).

9. Relationship To The Estate Tax.

a. **"Gross Up" Rule.** All gift taxes paid on any gifts made within three years of death will be included in decedent's gross estate. The three year period commences on the date of the gift.

i. **Illustration.** Donor 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[12], 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.

ii. **Outright Gifts Not Brought Back Into Estate.** In the preceding example, the $5 million dollar cash gift would not be brought back into the decedent's estate, since the transfer was complete at the time when it was made. However, as discussed below, some gifts themselves (in addition to the gift tax paid thereon) must also be brought back into the decedent's gross estate.

b. **Gifts Required to be Included in Gross 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.

i. **Operation of IRC Sections 2036, 2037, 2038 & 2042.** To understand which gratuitous transfers made by the decedent during his life will be

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[12] Tax imposed on gift of $5 million after application unified credit, which shields $1 million of the gift.

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.

ii. Estate Inclusion by Virtue of IRC §§2036, 2037, 2038 or 2042. 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.

iii. Decedent "Cuts the String" With Respect to Retained Interests. If the decedent "cuts the string" with respect to any of the above retained interests before his death, those provisions would no longer operate to require inclusion in the decedent's gross estate of those interests.

(1) Illustration. Assume the decedent, in 2006, executed a deed in favor of his daughter, but retained a life estate. In 2007, the decedent executed a quitclaim deed and forfeited his life estate. His daughter would then own a fee simple interest in the real estate. If the decedent died in 2006, before executing the quitclaim deed, the entire value of the property would be includible in his estate under IRC §2036. However, if the decedent died in 2008 after executing the quitclaim deed, IRC §2036 alone would not apply, since the interest he had formerly retained (i.e., the life estate) had been itself gifted to his daughter in 2008.

iv. Estate Inclusion by Virtue of IRC §2035(a)(2) and IRC §2036, §2037, §2038 or §2042. If the decedent, within three years of death, "cuts the string" with respect to any of these retained interests, a taxable gift will have been made at that time. Even so, the value of the property transferred would nevertheless be included in the decedent's estate under IRC §2035(a)(2).

(1) **Illustration.** Assume the same facts as in the above example. When decedent dies in 2008, IRC §2035(a)(2) applies because had the decedent not executing the quitclaim deed in 2006, the property would have been included in the decedent's gross estate. IRC §2035(a)(2) essentially ignores the transfer of the retained interest – the quitclaim deed in this case. Put another way, although the decedent did not possess any interest which would itself cause inclusion by virtue of IRC §2036 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 not executed the quitclaim deed, and had retained the life estate until his date of death.

(2) **Effect of IRC §2035(a)(2).** 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.

v. **Exception For Bona Fide Sale For Adequate Consideration.** 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).

vi. **Estate Inclusion Advantageous?** Inclusion in the decedent's gross estate by virtue of the application of IRC §2035(a)(2) may not 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).

vii. **Avoiding Three-Year Rule With Respect to Life Insurance.** 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 existing policy may also be transferred to an ILIT, the donor must survive for three years following the transfer to avoid estate inclusion under IRC §2035(a)(2). In TAM 200432015, the IRS ruled that the three year rule cannot be avoided by transferring a policy into an existing LLC for consideration in the form of membership interests. The ruling opined that the transfer was a testamentary substitute, and did not constitute a "bona fide sale for adequate and full consideration," so as to come within the exception provided in IRC §2035(d).

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viii. **Decedent's Estate Receives Credit for Gift Taxes Paid.** 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.