



# Successfully Completing a Gift Tax Return

## *Form 709*

myCPE

Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished)

# Today's presenter

## **Bob Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA**

Bob is a partner with Keebler & Associates, LLP and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. He is the author of more than 100 articles and columns and is the editor, author or co-author of many books and treatises on wealth transfer and taxation.

# Outline

- Basics of the Gift Tax
- Filing Requirements
- Marital Deduction – IRC Sec. 2523
- Gift Splitting – IRC Sec. 2513
- Adequate Disclosure – IRC Sec. 6501(c)(9)
- Generation Skipping Transfer Tax – IRC Sec. 2601
- Defined Value and Related Clauses
- Valuation Adjustments

# Basics of the Gift Tax

# Basics of the Gift Tax

## *Basis*

- Carryover basis – IRC §1015
  - Plus: amount of gift tax paid with respect to that gift
  - Not to exceed FMV

# Basics of the Gift Tax

## *Basis*

- If property gifted has a higher basis than value at the time of the gift, for purposes of calculating **loss**, the basis is limited to the value of the property at the time of the gift
  - Example: Alex purchased stock for \$15,000 and gives it to his son, Nicholas, when the value of the stock is \$10,000. Nicholas subsequently sells the stock for \$8,000. When measuring loss, Nicholas' basis is \$10,000. Therefore, Nicholas' loss is \$2,000

# Basics of the Gift Tax

## *Basis*

- If property gifted has a higher basis than value at the time of the gift, for purposes of calculating **gain**, the basis is the donor's basis at the time of the gift
  - Example: Alex purchased stock for \$15,000 and gives it to his son, Devin, when the value of the stock is \$10,000. Devin subsequently sells the stock for \$19,000. When measuring gain, Devin's basis is \$15,000. Therefore, Devin's gain is \$4,000

# Basics of the Gift Tax

## *Availability of Annual Exclusion*

- Present interest
  - Immediate use, possession, or enjoyment
  - Annual exclusion available
- Future interest
  - Donee does not have absolute right to the property at the present time
  - No annual exclusion



# Basics of the Gift Tax:

## *Availability of Annual Exclusion Crummey Trusts*

- Annual exclusion
- Withdrawal rights
- Crummey notices
  - Keep copies in file
  - File gift tax return to run SOL

# Basics of the Gift Tax:

## *Availability of Annual Exclusion 2503(c) Trusts*

- Annual exclusion available
  - The gifted property and the income from it may be expended by (or for the benefit of) the beneficiary before age 21
  - Passes to beneficiary at age 21, and
  - If the minor dies before reaching age 21, trust will revert to the minor's estate or will pass to the appointees of the beneficiary under a general power of appointment
  - Can be extended beyond 21

# Basics of the Gift Tax:

## *Deductions*

- Charitable deduction – IRC §2522
- Marital deduction – IRC §2523
- Both unlimited

# Basics of the gift tax:

## *Education And Medical Expenses*

- Unlimited exclusion – IRC §2503(e)
- Education – tuition
  - Does not include room and board
- Medical – includes insurance premiums
- Paid directly to education or medical facility
- HEET trust strategy

# Basics of the gift tax:

## *Qualified State Tuition Program*

- IRC §529
- Present interest
- Used for higher education
- Ratably over five years
  - Election on gift tax return
  - Attachment

# Filing Requirements

# Filing requirements

- Gifts not required to be reported when only gifts for the year:
  - Transfers that qualify for the annual exclusion
  - Transfers that qualify for the educational and medical expenses exclusion
  - Certain transfers for which the unlimited marital deduction is allowed
    - QTIP must be reported to elect QTIP treatment
  - Transfers of entire interests that qualify for the charitable deduction

# Filing Requirements:

## *Gift Tax Return Due Date*

- April 15
- If taxpayer dies:
  - No later than due date (with extensions) for estate tax return



# Filing Requirements

## *Extensions*

- Automatic six-month extension
- Income tax return
  - Form 4868
- Form 8892
  - Needs to be filed if gift tax return due
- Check box on return indicating extension

# Filing Requirements

## *Amended Returns*

- No special return
- File regular Form 709
  - Mark “amended”
  - Attachment explaining changes
- Extends the SOL

# Marital Deduction

# Marital Deduction

- Unlimited deduction – IRC Sec. 2523
- Requirements:
  - The spouses are married
  - The donee spouse is a U.S. citizen
  - The interest transferred is not a nondeductible terminable interest
  - The property interest transferred is not otherwise deducted for federal gift tax purposes
  - The gifts are included in the total taxable gifts for the year

# Marital Deduction

- Non-U.S. citizen spouse
  - Gifts do not qualify for marital deduction
  - Eligible for increased annual exclusion
    - \$155,000 in 2019
    - Must be gift of present interest
    - QTIP does not qualify

# Marital Deduction

## *QTIP Basics*

- Requirements:
  - All of the income from the property is payable to the spouse at least annually, and
  - No one (including the donee spouse) has a power to distribute or appoint the assets to any person other than the donee spouse during the donee spouse's lifetime (although testamentary powers are acceptable)
- Qualifies for unlimited marital deduction
- Irrevocable election

# Marital Deduction

## *QTIP Basics*

- Election made by listing the property on Schedule A, Part 1, and deducting the value of the trust on Part 4, line 4
- Partial QTIP elections allowed
  - Partial election using formula clause protects against change in value on audit

# Marital Deduction

## *QTIP Due Date*

- Can be made on an extended gift tax return
- **May not be made on a late filed gift tax return**
- Statutory deadline:
  - Relief under Treas. Reg. 301.9100-3 not available
  - However, an automatic six-month extension from the due date of a return excluding extensions is granted to make statutory elections, provided the taxpayer files return in a timely manner and taxpayer takes corrective action (file an original or a supplemental return) within that six-month extension period



# Gift Splitting

# Gift Splitting

- Treats all gifts made by one spouse as made half by each spouse
  - Cannot split gifts to spouse
- Each spouse must be a citizen or resident of the United States
- Individual considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year

# Gift Splitting

- Only applies if both spouses have signified their consent to gift splitting in the case of all such gifts made during the calendar year by either while married to the other
  - Executor can sign for deceased spouse
- Each spouse must sign the other spouse's return
  - Mailed to IRS in same envelope

# Gift Splitting

- Community property
  - Gift splitting generally not necessary
- In the case of split gifts, gifts attributed to the nondonor spouse are deemed adequately disclosed if the gifts are adequately disclosed on the return filed by the donor spouse

# Gift Splitting

- Consenting spouse need **not** file Form 709 if:
  - Only one spouse made gifts during the year and the total value of gifts made to any one donee is less than two times the annual exclusion (\$30,000 in 2020). All gifts must be gifts of a present interest
  - If both spouses make gifts during the year and the donor spouse does not make gifts in excess of two times the annual exclusion to any one donee, and all of the consenting spouse's gifts are no greater than the annual exclusion and payable to someone other than the donor spouse's donees. All gifts must be gifts of a present interest

# Gift Splitting

- Due date:
  - Consent to gift splitting may be signified at any time after the close of the calendar year in which the gift was made, subject to the following limitations:
    - Consent may not be signified after April 15<sup>th</sup> following the close of such year, unless before such day, no return has been filed for such year by either spouse, in which case the consent may not be signified after a return for such year is filed by either spouse
    - Consent may not be signified after a notice of deficiency with respect to the tax for such year has been sent to either spouse

# Gift Splitting

- Statutory deadline:
  - Relief under Treas. Reg. 301.9100-3 not available
  - However, an automatic six-month extension from the due date of a return excluding extensions is granted to make statutory elections provided the taxpayer files return in a timely manner and taxpayer takes corrective action (file an original or a supplemental return) within that six-month extension period

# Gift Splitting

- Not revocable after April 15<sup>th</sup> following the close of calendar year in which the gift was made if consent was made on or before April 15<sup>th</sup>
- Not revocable if consent was not signified until after April 15<sup>th</sup> following the close of calendar year in which the gift was made



# Gift Splitting

- Disadvantages:
  - Joint and several liability for gift tax
  - If donor spouse makes a gift and the nondonor spouse consents to gift split, the nondonor using part of the nondonor's spouse unified credit and the donor spouse dies within three years of making the gift, and the donor's gift is includible in the donor's gross estate, the nondonor spouse's unified credit is **not restored**

# Gift Splitting

- Gifts to third party and to spouse
  - Gifts to person other than spouse are only gifts eligible to gift split
  - When gift made to spouse and other person (e.g. gift to trust for benefit of spouse and children), gift to third party can be split if **severable and ascertainable** from gift to spouse
  - If spouse's interest not severable and ascertainable, gift splitting not allowed
    - If spouse's interest is severable and ascertainable, gift splitting not allowed for gift to spouse but is allowed for portion of gift to third party

# Gift Splitting

- Spouse's interest may be severable and ascertainable because of Crummey powers
  - Example:
    - Donor spouse establishes a trust for the benefit of the spouse and three children. The trust gives the nondonor spouse a Crummey power up to \$5,000 and the three children Crummey powers up to \$13,000. The donor spouse transfers \$83,000 to the trust. If all the necessary requirements are met, the entire \$83,000 transfer qualifies for split-gift treatment
    - The \$78,000 that can be withdrawn by the children qualifies as a split gift
    - The \$5,000 that can be withdrawn by the nondonor spouse does not qualify for gift splitting
    - See PLR 200130030

# Gift Splitting

- Spouse's interest severable and ascertainable
  - Example:
    - Donor spouse establishes a trust in which the spouse has a lifetime income interest in the trust and the children receive the remainder when the spouse dies
    - The portion of the gift that represents the spouse's lifetime income interest does not qualify for gift splitting
    - The portion of the gift that represents the children's remainder interest does qualify for gift splitting

# Gift Splitting

- Spouse's interest not severable and ascertainable
  - Example:
    - Donor spouse establishes a trust for the benefit of spouse and descendants. The trustee has complete discretion to make distribution to spouse and descendants
    - The portion of the gift to the spouse is not ascertainable. No portion of this gift can be gift split which means that no gifts on such gift tax return can be gift split

# Adequate Disclosure

## IRC Sec. 6501(c)(9)

# Adequate Disclosure:

## *Statute of Limitations for Assessing Additional Gift Tax*

- Statute of limitations is ordinarily three years after the later of:
  - The date the return was filed
  - OR
  - The date the return was due
- Time period increases to six years after the later of filing or due date if amounts omitted from the return exceed 25% of the amount reported

# Adequate Disclosure:

## *Effects of Running of the Statute*

- IRS cannot increase the amount of the initial gift
- IRS cannot increase the amount of a future gift based on an increase in the amount of the initial gift
- IRS cannot increase the amount of adjusted taxable gift included in the estate as a result of the gift



# Adequate Disclosure:

## *Disclosure Requirements*

- Pre-1990
  - No disclosure requirements
- Special valuation rules of Chapter 14
  - Statute of limitations would not run with respect to a gift subject to the special valuation rules under §2701 or §2702 unless there was adequate disclosure
  - Without adequate disclosure, additional tax could be assessed or a proceeding in court for collection of tax without assessment could be commenced at any time

# Adequate Disclosure:

## *Disclosure Requirements*

- Statute of limitations can begin running if an amended return is filed satisfying the adequate disclosure rules when the original return did not provide adequate disclosure
  - See Rev. Proc. 2000-34 - The top of the first page of the amended return must have the words “Amended Form 709 for gift(s) made in [insert the calendar year that the gift was made] — In accordance with Rev. Proc. 2000-34, 2000-34 I.R.B. 186.”

# Adequate Disclosure:

## *Disclosure Requirements*

- For gifts subject to §§ 2701 and 2702, a return must provide the following information:
  - A description of the transactions
  - The identity of, and relationship between, the transferor, transferee, and all other persons involved
  - A detailed description of the method used to determine the amount of the gift
  - Treas. Reg. §301.6501(c)-1(e)(1)

# Adequate Disclosure:

## *Disclosure Requirements*

- Taxpayer Relief Act of 1997
  - Added new disclosure rules for gifts not subject to Chapter 14
  - Applies to gifts made after **August 5<sup>th</sup>, 1997**

# Adequate disclosure:

## *Disclosure Requirements for Gifts Not Subject to Chapter 14*

- If a gift is adequately disclosed on a gift tax return it may not be revalued by the IRS for gift or estate tax purposes after the statute of limitations has run
- A transfer will be adequately disclosed if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the value so reported
- Two more specific adequate disclosure safe harbors are:
  - Detailed description safe harbor
  - Appraisal safe harbor

# Adequate Disclosure:

## *Information Required for Both Safe Harbors*

- A description of the transferred property and any consideration received by the transferor
- The identity of, and relationship between, the transferor and each transferee
- If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument
- 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

– Treas. Reg. §301.6501(c)-1(e)(2)

# Adequate Disclosure:

## *Information Required For Detailed Description Safe Harbor*

- The following additional information is required:
  - Any financial data (e.g., balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the property interest
  - Any restrictions on the transferred property that were considered in determining the fair market value of the property
  - A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property

# Adequate Disclosure:

## *Information Required for Detailed Description Safe Harbor*

- In the case of a transfer of an interest that is actively traded on an established exchange, the following information will satisfy all additional requirements:
  - Recitation of the exchange where the interest is listed
  - The CUSIP number of the security
  - The mean between the highest and lowest quoted selling prices



# Adequate Disclosure:

## *Information Required for Detailed Description Safe Harbor*

- For an interest in an entity that is not actively traded, the following rules apply
  - A description of any discounts claimed in valuing the assets
  - If the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, an additional statement must be provided

# Adequate Disclosure:

## *Information Required for Appraisal Safe Harbor*

- An appraisal can be submitted in lieu of the information required for the detailed description safe harbor
- The appraisal must be prepared by a qualified appraiser

# Adequate Disclosure:

## *Information Required for Appraisal Safe Harbor*

- The appraisal must contain:
  - The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal
  - A description of the property
  - A description of the appraisal process employed
  - A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property
  - The information considered in determining the appraised value

# Adequate Disclosure:

## *Information Required for Appraisal Safe Harbor*

- The appraisal must contain (cont.):
  - The appraisal procedures followed and the reasoning that supports the analyses, opinions, and conclusions
  - The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred
  - The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

# Adequate disclosure:

## *Non-Gift Completed Transfers*

- Completed transfers to members of the transferor's family that are made in the ordinary course of business
  - Transfers are deemed to be adequately disclosed even if the transfer is not reported on a gift tax return if the transfer is properly reported by all parties for income tax purposes
- Other property transfers reported as nongift transfers must satisfy two requirements to be considered adequately disclosed:
  - The general information required for both safe harbors must be provided
  - There must be an explanation of why the transfer is not a gift under Chapter 12 of the Code

# Adequate Disclosure:

## *Adequate Disclosure of Incomplete Transfers*

- Adequate disclosure of a transfer that is reported as a **completed gift** on the gift tax return commences the running of the statute of limitations even if the transfer is ultimately determined to be **incomplete** for gift tax purposes (for example, donor retained limited power of appointment)
- If such a transfer is adequately disclosed, after the running of the statutory period the transfer will be included in the donor's gross estate only to the extent that a completed gift would be so included

# Adequate Disclosure:

## *Procedural Issues*

- Failure to disclose on a timely filed return can sometimes be corrected
  - An original return would evidently start the statute even if it is filed late
  - A timely filed amended return should start the statute
  - A late-filed amended return would not start the statute
  - Filing of a false return, a fraudulent return, or no return at all will not start the statute of limitations

# Generation Skipping Transfer Tax



# Generation skipping transfer tax

- Purpose of GST tax
- Lifetime exemption
  - \$11,400,000 – 2019
  - \$11,580,000 – 2020
  - Can be allocated to direct skips or to transfers in trust that may result in future taxable distributions or terminations

# Estate Tax Erosion Example:

*40% Tax Rate*

Wealth of Parents	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000
Estate Tax Rate	40%	40%	40%
<b>Estate Tax</b>	<b>\$ 4,000,000</b>	<b>\$ 4,000,000</b>	<b>\$ 4,000,000</b>
Wealth of Children	\$ 6,000,000	\$ -	\$ -
Estate Tax Rate	40%	40%	40%
<b>Estate Tax</b>	<b>\$ 2,400,000</b>	<b>\$ -</b>	<b>\$ -</b>
Wealth of Grandchildren	\$ 3,600,000	\$ 6,000,000	\$ -
Estate Tax Rate	40%	40%	40%
<b>Estate Tax</b>	<b>\$ 1,440,000</b>	<b>\$ 2,400,000</b>	<b>\$ -</b>
<b>Wealth of Great-Grandchildren</b>	<b>\$ 2,160,000</b>	<b>\$ 3,600,000</b>	<b>\$ 6,000,000</b>
<b>% of Original Wealth Passing to Great-Grandchildren</b>	<b>21.6000%</b>	<b>36.0000%</b>	<b>60.0000%</b>

# Generation Skipping Transfer Tax

- Timely allocation permits use of date-of-gift value for purposes of allocation
- Late allocation requires use of values as of date return is filed
  - Special first of the month rule
    - Treas. Reg. §26.2642-2(a)(2)
    - **Example:** David made a \$100,000 gift to a dynasty trust in 1999 but did not allocate GST exemption on the gift tax return. David files a gift tax return in January 2020 in order to allocate GST exemption to the trust. He must use the value of the trust on January 1, 2020 to fully allocate GST exemption to the trust.

# Generation Skipping Transfer Tax

- Skip person:
  - Person two or more generations below
    - Grandchildren
  - Nonrelative more than 37½ years younger
  - Certain trusts – all interests held by skip persons
- Non-skip person:
  - Anyone not a skip person

# Generation Skipping Transfer Tax

- Direct skips:
  - Gift to skip person
- Indirect skips:
  - Not a direct skip
  - Subject to gift tax
  - Made to a GST Trust

# Generation Skipping Transfer Tax

- Taxable termination:
  - The termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless:
    - Immediately after such termination, a non-skip person has an interest in such property, or
    - At no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.
    - **Example:** After a child's death, a trust terminates and distributes the trust assets to a grandchild

# Generation Skipping Transfer Tax

- Direct skip
  - A transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person
  - **Example:** Outright transfers to grandchildren
- Taxable distribution
  - Any distribution from a trust to a skip person (other than a taxable termination or a direct skip)
  - **Example:** a distribution from a trust to a grandchild

# Generation Skipping Transfer Tax

- GST annual exclusion:
  - Currently \$15,000 (2018-2020 amount)
  - Available to direct skips
  - Trusts can only qualify if:
    1. Single beneficiary: during the life of the beneficiary, no distributions may be made to anyone other than the beneficiary; and
    2. Inclusion in beneficiary's estate: at the individual's death, if the trust is still in existence, the trust assets will be included in the beneficiary's gross estate
- IRC §2642(c)



# Generation Skipping Transfer Tax:

## *Inclusion Ratio*

- The proportion of the trust that is subject to GST tax
- More correctly, it's a factor in determining the GST tax rate
- Tax rate = (top estate tax rate) X inclusion ratio

$$\bullet \left[ 40\% \times \left( 1 - \frac{\text{Amount of the GST Exemption Allocated to the Trust}}{\text{the value of the property transferred to the trust} - (\text{any federal estate tax or state death tax actually recovered from the trust attributable to such property} + \text{charitable deduction allowed})} \right) \right]$$

# Generation Skipping Transfer Tax:

## *Inclusion Ratio/Applicable Fraction*

- Example – **0 Inclusion Ratio:**

- In 2011, Lydia transfers \$50,000 to a trust for the benefit of her children and grandchildren. On a timely filed Form 709, she allocates \$50,000 of her GST exemption of this transfer. In 2020, the trustee of the trust makes a \$10,000 distribution to Lydia's grandchild from the trust. The GST tax rate on the \$10,000 taxable distribution (i.e. the taxable distribution) is calculated as follows:

- $40\% \times \left( 1 - \left( \frac{\$50,000}{\$50,000} \right) \right)$ , which =  $40\% \times (1-1)$ , which =  $40\% \times 0$ , which = 0% tax rate

- \$10,000 distribution X 0% tax rate = \$0 GST tax due

# Generation Skipping Transfer Tax:

## *Inclusion Ratio/Applicable Fraction*

- Example – **1 Inclusion Ratio**:

- In 2011, Lydia transfers \$50,000 to a trust for the benefit of her children and grandchildren. Lydia does not allocate any GST exemption to this transfer. In 2020, the trustee of the trust makes a \$10,000 distribution to Lydia's grandchild from the trust. The GST tax rate on the \$10,000 taxable distribution (i.e. the taxable distribution) is calculated as follows:

- $40\% \times \left( 1 - \left( \frac{\$0}{\$50,000} \right) \right)$ , which =  $40\% \times (1-0)$ , which =  $40\% \times 1$ , which = 40% tax rate

- \$10,000 distribution X 40% tax rate = \$4,000 GST tax due

# Generation Skipping Transfer Tax:

## *Inclusion Ratio/Applicable Fraction*

- Example – Mixed Inclusion Ratio:

- In 2011, Lydia transfers \$50,000 to a trust for the benefit of her children and grandchildren. On a timely filed Form 709, she only allocates \$40,000 of her GST exemption of this transfer. In 2020, the trustee of the trust makes a \$10,000 distribution to Lydia's grandchild from the trust. The GST tax rate on the \$10,000 taxable distribution (i.e. the taxable distribution) is calculated as follows:

- $40\% \times \left( 1 - \left( \frac{\$40,000}{\$50,000} \right) \right)$ , which =  $40\% \times (1-.8)$ , which =  $40\% \times .2$ , which = 8% tax rate

- \$10,000 distribution X 8% tax rate = \$800 GST tax due

# Generation Skipping Transfer Tax:

## *Predeceased Parent Rule*

- For purposes of determining whether any transfer is a generation-skipping transfer, if:
  - An individual is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and
  - Such individual's parent who is a lineal descendant of the parent of the transferor (or the transferor's spouse or former spouse) is dead at the time the transfer (from which an interest of such individual is established or derived) is subject to estate or gift tax imposed upon the transferor (and if there shall be more than one such time, then at the earliest such time)

# Generation Skipping Transfer Tax:

## *Predeceased Parent Rule*

Such individual shall be treated as if such individual were a member of the generation which is one generation below the lower of the transferor's generation or the generation assignment of the youngest living ancestor of such individual who is also a descendant of the parent of the transferor (or the transferor's spouse or former spouse), and the generation assignment of any descendant of such individual shall be adjusted accordingly

# Generation Skipping Transfer Tax:

## *Predeceased Parent Rule*

- **Example:**

- Ray's child, Hannah, died in 2019
- Hannah was survived by one child, Jolene
- In 2020, Ray made an outright gift to Jolene
- Under this rule, Jolene moved up one generation at her mother's death and the 2020 gift from Ray is not considered a gift to a skip person for GST purposes

# Generation Skipping Transfer Tax:

## *Automatic Allocation Rules*

- Lifetime direct skips
  - Example: Gift to grandchild
- Automatic allocation rules for “indirect skips”
- Indirect skip – a transfer that is not a direct skip that is made to a “GST Trust”
- “GST Trust” – any trust that could have a taxable termination or taxable distribution unless one of six exceptions applies



# Generation Skipping Transfer Tax:

## *Automatic Allocation*

- Automatic allocation
  - Direct skips
  - GST trust
    - Election into automatic allocation
    - Election out of automatic allocation

# Generation Skipping Transfer Tax:

## *Automatic Allocation*

- Elections into or out of automatic allocation:
  - Attach to Form 709
  - Describe the transfer and the extent to which the automatic allocation is not to or is to apply
  - Reporting a direct skip on a timely filed Form 709 and paying the GST tax on the transfer qualifies as an election out of automatic allocation
  - Once made, the election is irrevocable after the due date of the Form 709 on which it is made
  - Election can be made for all future transfers to such trust – remains in effect unless and until terminated

# Generation Skipping Transfer Tax

- Where to place on Form 709:
  - Non-GST Trusts – Part 1
    - Example: Gift to trust fbo children, with children having GPOA
- GST Trusts – Part 3
  - Example: gifts to dynasty trust
- Direct Skip Trusts – Part 2
  - Example: gifts to 2642(c) trust

# Generation Skipping Transfer Tax

- Allocation during estate tax inclusion period “ETIP” (i.e., period asset would be included in donor’s estate)
  - Not allowed
  - Allocated at end of ETIP based on value at such time
    - Automatic for indirect skip trust
    - Election out can be made on (i) the gift tax return reporting the transfer to the trust, or on (ii) a gift tax return filed for any calendar year after the year of the transfer, up to and including the calendar year in which the ETIP closes

# Defined Value and Related Clauses

# Defined Value and Related Clauses

- Attempt to avoid risk associated with increase in value of gift on audit
- Set the value of the property transferred equal to its value as finally determined for federal gift tax purposes

# Defined Value and Related Clauses

- Four ways to structure:
  - Provide that any excess value returns to the donor
  - Provide that any excess value passes to another person or entity/charity (overflow clause)
  - Transfer all the property, but adjust the price to the value as finally determined for federal gift tax purposes, or
  - Use a formula allocation clause

# Defined Value and Related Clauses

## Example:

- Betty Smith wishes to gift units in the Smith FLP to her son Bill. Each unit has an undiscounted value of \$2,000. Betty gifts 10,000 units to Bill and claims minority interest and lack of marketability discounts totaling 50 percent. This reduces the value of the property transferred from \$2,000,000 (10,000 units x \$200/unit) to the \$1,000,000. The IRS audits the return and Betty ends up with a 20 percent discount instead of 50 percent. The value of the FLP units as finally determined for federal tax purposes is \$160/unit instead of \$100/unit
- \$600,000 worth of FLP units would go back to Betty. Given the \$160/unit value as finally determined for federal gift tax purposes, Betty would transfer 6,250 units (6,250 units x \$160/unit = \$1,000,000) and 3,750 units would return to her



# Defined Value and Related Clauses

- Provide that any excess value passes to another person or entity (overflow clause)
  - Transfer a fixed number of units, but provide that they will be split between the donee and a second person or entity
  - The donee would receive units having a stated value and any excess value would pass to the second party

# Defined Value and Related Clauses

## Example:

- Betty Smith wishes to gift units in the Smith FLP to her son Bill. Each unit has an undiscounted value of \$2,000. Betty gifts 10,000 units to Bill and claims minority interest and lack of marketability discounts totaling 50%. This reduces the value of the property transferred from \$2,000,000 (10,000 units x \$200/unit) to the \$1,000,000. The IRS audits the return and Betty ends up with a 20% discount instead of 50%. The value of the FLP units as finally determined for federal tax purposes is \$160/unit instead of \$100/unit
- Betty included a clause stating that any she was transferring 10,000 units to split between Bill and a charity. Bill would receive whatever number of units turned out to have a value of \$1,000,000 as finally determined for federal gift tax purposes, and the charity would receive the rest
- Under our facts, Bill would receive 6,250 units and the charity would receive 3,750 units
- The overflow amount could also be transferred to a spouse, a zeroed-out GRAT or a limited power of appointment trust

# Defined Value and Related Clauses

- Court favored clauses:
  - An overflow clause to charity
    - For very cautious taxpayers or taxpayers with strong charitable intent
    - Safer than a *Wandry* Clause:
      - Three Tax Court cases approving it: (Christiansen (8<sup>th</sup> Cir.), Petter (9<sup>th</sup> Cir.) and Hendrix (5<sup>th</sup> Cir.))
      - The charitable lid has also been approved by two circuits courts of appeals (8<sup>th</sup> and 9<sup>th</sup> Circuits)
      - IRS public policy argument may be weaker when there is a charitable beneficiary
      - Charity has a strong interest in ensuring a fair valuation. Future courts may not find the argument that the self-interest of family members provides a mechanism for ensuring fair valuation like the interest of a charity does

# Defined Value and Related Clauses

- Reporting issues
  - Adequate disclosure
  - Attachment of deed of gift/trust
  - Wording of gift description
    - *Wandry*

# Valuation Adjustments and Penalties

# Valuation Adjustments

- Minority interest discount
- Marketability discount
- Fractional interest discount
- Gift tax return
  - Check box
  - Attach valuation report/fractional interest statement

# Penalties

- Potential Penalties – Taxpayer

- *Accuracy-Related Penalty*

- IRC §6662
- 20% on portion of an underpayment that is attributable to one or more of the following:
  - Negligence or disregard of the rules or regulations
  - Any substantial estate, generation-skipping transfer, or gift tax valuation understatement (65% test)
  - Transactions lacking economic substance
- Defense: taxpayer had reasonable cause for taking the position on the tax return that caused the underpayment and acted in good faith

# Penalties

- Potential Penalties – Taxpayer

- *Negligence or Disregard of Rules or Regulations*

- IRC §6662(b)(1)
- 20% for (1) negligence or (2) disregard of rules or regulations
- Taxpayer can avoid the disregard penalty for positions contrary to revenue rulings and notices by:
  - Making adequate disclosure (Form 8275/8275-R) or
  - By showing the position has a “realistic possibility of being sustained on its merits”
    - » Approximately 33% or better chance that tax position will be sustained on its merits
  - Reasonable cause/good faith defense



# Penalties

- Potential Penalties - Preparer

- *Unreasonable Position*

- IRC §6694
- A preparer who prepares a return or claim for refund for which any part of an understatement of liability is due to an unreasonable position (and the preparer knew, or should have known, of the position) is liable for a penalty in an amount equal to the greater of (1) \$1,000 or (2) 50% of the tax return preparation fees

# Penalties

- Potential Penalties - Preparer
  - *Unreasonable Position*
    - Position is unreasonable unless there is or was substantial authority for the position
    - For a disclosed position (which is not a reportable transaction or tax shelter), the position is unreasonable unless there is a reasonable basis for the position
      - Disclose: Form 8275/8275-R
    - For a tax shelter or reportable transaction, a position is unreasonable unless it is reasonable to believe that the position will more likely than not be sustained on its merits

# Penalties

- Potential Penalties – Appraiser

- *Appraiser Penalty*

- IRC §6695A
- If a person prepares a property appraisal, and such person knows (or reasonably should have known) that the appraisal would be used in connection with a return or a claim for refund, that person is subject to a penalty if the claimed property value results in:
  - A substantial gift tax valuation misstatement or
  - A gross gift tax valuation misstatement
- Penalty equals the lesser of:
  - the greater of: 10% of the underpayment or \$1,000 or
  - 125% of the gross income received by the appraiser for the appraisal services
- Defense: appraiser establishes that the appraised value was “more likely than not” the proper value

# Sample Form Review

# Q&A

We will now answer viewer questions that have come in during the webinar.

Thank you!