DISCLOSURE SETS A TIME LIMIT ON IRS GIFT REVALUATION

Practitioners should make use of a mechanism for preventing the IRS from revaluing lifetime gifts when auditing an estate.

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Lifetime gifts of hard-to-value property have often created trouble years later when the donor dies and the IRS audits the estate tax return. In some instances, the Service has succeeded in raising the values of gifts and increasing the estate tax bills of donors who died many years after making the gifts at issue.

TRA '97 and the Internal Revenue Service Restructuring and Reform Act of 1998 ("1998 Act") continue a legislative trend aimed at fixing the values of gifts before a donor dies. TRA '97 generally requires that the IRS question the values of post-8/5/97 gifts within three years after they are adequately disclosed. On the other hand, the 1998 Act permits the IRS to specify a value that is permanent if it is not contested by the donor within that limitations period. These carrot-and-stick changes to the transfer tax rules generally benefit taxpayers dying after 4/15/01, but the new rules also place additional responsibility on practitioners, particularly if the property given by a doner is hard to value.

Background

Federal estate and gift taxes are unified. A single progressive rate structure, from 18% to 55%, applies to an individual's cumulative gifts and bequests. Each year's gifts qualifying under Section 2503(b) are reduced by the annual, per donee $10,000 (adjusted for inflation for gifts made after 1998) gift tax exclusion ($20,000, if the donor's spouse agrees to gift-splitting). Gift tax on the remainder of the year's gifts is then computed. The taxpayer's lifetime "applicable credit amount," known before TRA '97 as the unified tax credit, is offset against the tax. This shelters the equivalent of $650,000 of gifts, as of 1/1/99 (and rises in steps to $1 million in 2006).[1]

Once the credit is exhausted, the donor pays gift tax on all subsequent taxable gifts. Each year's gifts are added to those made in later years, pushing the donor's cumulative lifetime gifts into ever higher tax brackets. Under Section 2502(a), gift tax already paid is subtracted from the gift tax computed on the cumulative total of lifetime gifts.

On the donor's death, all gifts made after 1976 are added to the value of his or her estate to

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determine the total tax for all transfers during life and at death. Tax on this cumulative total beyond the applicable credit amount is reduced by gift tax paid after 1976, and any remaining tax is due.[2]

Before TRA '97, this process was complicated by the Service's ability to revalue a gift at any time if the donor's unified tax credit/applicable credit amount was used to eliminate gift tax on that transfer (i.e., if the donor did not actually pay gift tax).

Example. John, a single taxpayer, gave shares of stock in a small business to his daughter in 1987. John valued the stock at $300,000 on Form 709, U.S. Gift Tax Return. His $10,000 annual gift tax exclusion reduced the taxable portion of the transfer to $290,000. Then John used a portion of his unified tax credit to eliminate gift tax on the $290,000. After 1987, John made other gifts that used up the remainder of his unified tax credit. He died in 1998 and, after Form 706, U.S. Estate Tax Return, was filed, the IRS claimed that the 1987 gift to his daughter had a fair market value of $800,000. If the Service prevails, the gift/estate tax bill could increase by perhaps $200,000 or more, and the estate may also owe penalties and interest.

Prior to TRA '97, a gift for which the donor paid gift tax, as opposed to using part of the unified tax credit, was exposed to revaluation for only three years after Form 709 was filed. It was not possible to "voluntarily" pay gift tax, however. The law requires a donor to use up his or her tax credit before paying gift tax.

Gifts made since the passage of TRA '97 (i.e., 8/5/97) generally are protected by the three-year rule whether the donor pays gift tax or is shielded by the applicable credit amount, under Sections 2001(f) and 2504(c). The Service may attempt to revalue gifts during the three years following the filing of gift tax returns, but if it does not do so, the value assigned to a gift on Form 709 is the value used when the donor's estate tax return is prepared. The first post-TRA '97 gifts were reported on gift tax returns filed on 4/15/98. The estates of taxpayers dying after 4/15/01 (i.e., three years later) will begin to reap the rewards of the change.

PRACTICE NOTES

1. **The IRS generally has only three years to challenge the valuation of post-8/5/97 gifts, provided they were adequately disclosed when the gift tax return was filed—even if no gift tax was due. On the other hand, a value that the IRS specifies becomes binding if not contested by the donor within that limitations period.**
2. **Adequate disclosure is especially useful when the gift consists of hard-to-value property that uses up only a portion of the applicable credit amount. The IRS is less likely to challenge the valuation because no tax could be collected unless the revalued gift exceeded the credit amount.**
3. **The best strategy may be to report all hard-to-value gifts, even if they appear to be sheltered by the $10,000/$20,000 annual gift tax exclusion.**

Greatest benefit

In the example above, if John had made the gift in November 1997 and adequately disclosed it on his 1997 Form 709 filed 4/15/98, the IRS could not challenge the value for gift or estate tax purposes after 4/15/01. This change is especially important for a client who gives hard-to-value property that uses up only a portion of the applicable credit amount. The reason is that the remainder of the credit amount provides a cushion between the gift's value on Form 709 and payment of any gift tax. This cushion reduces the likelihood of IRS audit because the Service's limited resources generally lead it to audit returns where immediate recovery of tax (and cash) appears greatest. John's cushion increases the chance that the limitations period will run without audit, and the $290,000 value will be "locked in."

Suppose John made the gift in 1997 when the applicable credit amount was $600,000. The IRS must successfully increase the property's value by more than $310,000 ($600,000 less $290,000) before any gift tax is due. If the Service succeeded in raising the gift's value to $500,000 or $600,000, John's *estate* tax bill would eventually be higher, but who knows when he might die? There would be no immediate cash benefit to the IRS. Hence, the IRS would have little incentive to question the gift's value.

Adequate disclosure

The three-year limit applies only to gifts that are adequately disclosed on a gift tax return. If a gift is not reported or is not properly disclosed on Form 709 or in an attachment that

adequately apprises the IRS of the item's nature, the IRS is not bound by the new rule. It may attempt to revalue the gift at any time, including on the estate tax return, according to Section 6501(c)(9).

Example. Freda gave 1,000 shares of stock in a closely held corporation to her brother in 1998. The value of the stock was difficult to determine because it represented a minority interest in an enterprise that, at the time, had an uncertain future. Freda did not report the gift on Form 709. Soon afterward, the corporation obtained contracts that not only ensured its survival but also made it extremely profitable. Regardless of when Freda dies, this gift is a time bomb, subject to revaluation on her estate tax return with an attendant increase in her federal estate tax. If the tax exceeds Freda's estate, the IRS may be able to collect the excess from her brother under Section 6324(a)(2).

THE THREE-YEAR LIMIT APPLIES ONLY TO GIFTS THAT ARE ADEQUATELY DISCLOSED ON A GIFT TAX RETURN.

With this in mind, a client might be well advised to report all gifts that are difficult to value, even if they appear to be sheltered by the $10,000/$20,000 annual gift tax exclusion. Small gifts that appear harmless during a client's lifetime may be costly if revalued after death.

How to disclose. A gift of publicly traded stock or similar item with an easily ascertainable value generally poses no challenge for disclosure on Form 709. Often, however, a gift is a partial interest in a closely held (perhaps family-owned) business or is some other hard-to-value item. The property may not be easily marketable, may represent a minority interest in an enterprise, or may have other constraints that hinder the determination of its worth. The opinions of appraisers as to the value of the gift and any applicable discounts may vary substantially. A client may insist that an aggressive (i.e., low) value be reported in order to save gift tax now and estate tax later.

In any case, the client's best interest requires that the three-year limitations period begin running. Under Section 6501(c)(9), this is triggered by adequate disclosure in Form 709 or in a statement attached to it. Although gifts fall under Chapter 12 of the Code, the best advice on disclosure relates to Chapter 14, which covers special valuation rules for certain transfers of corporate or partnership interests. Reg. 301.6501(c)-1(e)(2) provides that adequate disclosure for Chapter 14 purposes includes all of the following:

1. A description of the transaction, including a description of transferred and retained interests and the method or methods used to value each.
2. The identity of, and relationship between, the transferor, transferee, all other parties participating in the transaction, and all parties related to the transferor holding an equity interest in any entity involved in the transaction.
3. A detailed description (including all actuarial factors and discount rates employed) of the method used to determine the value of the gift transferred.
4. For an equity interest that is not adequately traded, the financial and other data used in determining value, generally including balance sheets and statements of net earnings, operating results, and dividends paid for each of the five years immediately preceding the valuation date.

These provisions of the regulation were effective as of 1/28/92. The IRS may now revise them to require additional disclosure because of the three-year limit, especially in light of recent judicial interpretation of "adequate disclosure."

Because of a family dispute, the executor in *Williamson*[3] was unable to identify or value certain items that were includable in an estate. The executor timely filed a federal estate tax return, attaching an extension request form that simply explained the circumstances. The return disclosed no additional information about the items because none was available. Yet, the Tax Court felt that this was adequate disclosure to the IRS, ruling that:

- Disclosure must be sufficiently detailed that the Service can make a "reasonably informed" decision as to whether to audit the return.
- On the other hand, adequate disclosure does not imply a detailed description of every underlying fact.
- Dollar amounts are not always necessary.

In *Williamson*, the judge relied on *The Colony, Inc.*,[4] in which the U.S. Supreme Court appeared to set a low threshold for adequate disclosure. In *The Colony, Inc*, the court decided that the IRS is at a disadvantage in detecting errors when items are omitted from

a return, but is not so hampered when items are disclosed—even if the disclosure is in error.

The 1998 Act gives the IRS a weapon to use in such circumstances. Act section 6007(e)(2)(B) amends Sections 2001(f) and 2504(c) to make the three-year rule work both ways. Under revised Sections 2001(f)(1) and (2), and 2504(c), the Service may value a gift and, unless the taxpayer contests the Service's number within the three-year window, that amount becomes the value as "finally determined." Alternatively, a value may be determined by a settlement agreement with the Service or by a court. The latter dovetails with Section 7477 which permits the Tax Court to declare the value of a gift, in the event of a controversy, after the taxpayer exhausts all available administrative remedies.

Sample disclosures. No one wishes to flag an item, thereby inviting an audit of Form 709 and a possible attempt to revalue the gift, but the post-TRA '97 opportunity to bar the IRS from revaluing items on the estate tax return is too good to refuse. Also, the 1998 Act's empowerment of the IRS to unilaterally determine a value that is permanent if not contested by the end of the limitations period gives additional motivation. For a taxpayer, the result may be a difference of several hundred thousand dollars in estate tax; for a practitioner, failure to take advantage of the three-year rule might raise the issue of malpractice.

A hard-to-value gift that practitioners often see is shares of stock that represent less than a controlling interest in a closely held corporation. Although circumstances and appropriate disclosure vary widely, some of the information to be provided on Form 709 might appear as follows:

1. The item transferred was 1,000 shares of common stock, representing 20% of the 5,000 common shares in ABC Corporation, a privately held entity now entirely owned by four persons. The transferor formerly owned 2,500 common shares, or 50% of the enterprise and now owns 1,500 common shares, or 30%. ABC Corporation has no preferred stock outstanding; thus, the 5,000 common shares represent the entire equity ownership of the enterprise. Valuation procedures, including a minority discount, were applied to the stock transferred in accordance with Rev. Rul. 59-60[5] and Reg. 20.2031-2(f).
2. The transferor, Martha Smith, is the aunt of the transferee, Jack Smith. No other parties participated in the transaction. One other shareholder, Alvin Smith, who owns 500 common shares as community property with his wife, Sally Smith, is related to both Martha Smith and Jack Smith. Alvin Smith is Martha Smith's brother and Jack Smith's father. Sally Smith is Jack Smith's mother. No other shareholder of ABC Corporation is related to Martha Smith, Jack Smith, Sally Smith, or Alvin Smith, and no other entities were involved in the transaction.
3. A detailed description of the methods used in valuing the stock transferred to Jack Smith is provided in the appraisal attached to this return as Exhibit A.
4. Since the stock of ABC Corporation is not actively traded, the financial and other data used in computing the value of the stock transferred, including financial statements and information on dividends for the last five years, are presented in the attached appraisal.

The authors assume that a client will engage a qualified appraiser for an asset that is hard to value. If the client does not, it is essential that the practitioner specify in detail the methods used to arrive at the valuation, along with financial data to support it.

Remember to check "Yes" or "No" concerning a valuation discount at the top of Schedule A on Page 2 of Form 709.

SMALL GIFTS THAT APPEAR HARMLESS DURING A CLIENT'S LIFETIME MAY BE COSTLY IF REVALUED AFTER DEATH.

Additional tax issues

Although this article focuses on avoiding revaluation of lifetime gifts after an estate tax return is filed, other considerations affected by the value of gifts and of the estate are also important in certain circumstances. These include the following:

- The executor must choose whether to value a decedent's estate at the date of death or to use the Section 2032 alternate valuation date. When the values of large lifetime gifts are already settled, the decision is less complicated.
- If the value of a decedent's interest in a closely held business exceeds 35% of the adjusted gross estate, an extension of time to pay estate tax may be available under Section 6166. The estate also may be able to redeem stock with little or no

income tax under Section 303 to pay death taxes. The value of stock owned by certain family members may be included to meet the threshold.

- A decedent owning an interest in a closely held business may qualify to shelter up to $1.3 million of the business' value from estate tax by using Section 2057 (formerly Section 2033A) and the decedent's applicable credit amount.[6] The adjusted value of the decedent's qualified family-owned business interest passing to qualified heirs must exceed 50% of the decedent's adjusted gross estate. Certain lifetime transfers are considered.
- If business real estate is at least 25% of the adjusted gross estate, and business realty and personal property amount to 50% or more, an up-to-$750,000 (adjusted for inflation for estates of decedents dying after 1998) discount may be taken on the real estate under Section 2032A.
- Certain gifts of corporate stock and partnership interests are subject to additional valuation rules under Section 2701.
- A substantial estate or gift tax valuation understatement may be subject to a penalty under Section 6662(g).
- If property is overvalued on Form 709, Section 6511(a) requires that a claim for credit or refund be filed within three years of the date Form 709 was filed or two years from payment of the tax, if later.
- An existing buy-sell agreement between business owners may specify a method for computing the value of business interests that differs from the method chosen for gift tax purposes. A buy-sell agreement may even require different appraisal methods for different circumstances (e.g., a buy-out because of conflict between owners vs. a buy-out after the death of an owner). The valuation discrepancies produced by these various methods indicate the potential for valuation disputes with the IRS.
- Valuation for gift tax purposes should consider valuation for other purposes involving the property, such as generation-skipping transfers, grantor retained unitrusts and annuity trusts, and charitable lead and remainder trusts.

Conclusion

Law changes enacted in recent years offer an opportunity to clients and present a challenge to practitioners both before and after Form 709 is filed. Since the Service's authority to challenge the valuation of an adequately disclosed gift generally terminates three years after a gift is reported, exposure to revaluation is limited for taxpayers dying after 4/15/01. A practitioner must ensure that disclosure is sufficient to start the limitations period running, however, especially if a gift is difficult to value. Further, because a taxpayer's opportunity to contest an IRS valuation of property also ends with the statutory period, the practitioner's responsibility to make best use of Form 709 and follow up on IRS actions is now greater than ever. ■

NOTES

1 Sections 2010(a) and (c).
2 Section 2001(b).
3 TCM 1996-426.
4 357 U.S. 28, 1 AFTR2d 1894 (1958).
5 1959-1 CB 237.
6 See Oliver, "The New Family-Owned Business Estate Tax Exclusion," 59 TA 193 (October 1997); Kertz, "TRA '97 Eases the Estate and Gift Tax Burden," 59 TA 252 (November 1997).