BRIAN T. WHITLOCK, J.D., LL.M., is a practicing attorney and a retired CPA.

Untaxingly Yours

Making a Gift Tax Return (Check) List and Checking It Twice

By Brian T. Whitlock

August is not generally thought of as "gift giving season," but for many tax professionals it is the time of year when we are catching up on tax compliance and focusing staff on the preparation of gift tax returns.

Calendar Year-End 2020 Gift Giving Frenzy

Calendar year-end 2020 proved to be an active time for the clients of many wealth transfer advisors. The November election brought change in the Presidency and cast a foreboding light on the ultimate voting control of the Senate. In early 2021, the tide of change aligned both Houses of Congress with the White House and prompted the creation of a new wave of legislative action.

Fearing potential 2021 legislative changes, many advisors succeeded last November and December in motivating their clients to exhaust much of the unused portion of their 2020 Applicable Estate and Gift Tax credit equivalent amounts by making large taxable gifts. These 2020 gifts must now be reported by taxpayers on their respective IRS Form 709, *United States Gift (and Generation Skipping Transfer) Tax Returns* ("Gift Tax Returns").

Gift Tax Return Due Dates

The nominal due date for Gift Tax Returns is generally April 15. As with many returns, taxpayers are permitted to request an automatic six-month extension of time to file Gift Tax Returns. IRS Form 709 can be extended by using either IRS Form 4868, which simultaneously extends the same taxpayer's individual income tax return, IRS Form 1040; or by filing IRS Form 8892, *Application for Automatic Extension of Time to File Form 709*. Neither extension extends the time to pay any tax that may be due in excess of any exclusion, credit, or exemption.

If you are not also extending the time for filing the Form 1040, then Form 8892 is the appropriate extension form. Form 8892-V can also serve as a payment voucher if a taxpayer is making a payment for gift tax purposes. IRS Notice 2021-21 released on March 29, 2021 extended the initial due date for Form 1040 filings and tax payments for the second pandemic year in a row this time until May 17, 2021. The Notice created massive confusion among tax compliance groups, since it appeared to create a due date of May 17 for Form 4868 extension filers and

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April 15 for Form 8892 extension filers. This confusion was not formally resolved by the IRS in follow-up IRS Notice or Announcement.

Practical Reasons for Extensions

Extending the filing of most gift tax returns is a necessary evil in smoothing out due date compression. Among the most common reasons to extend are:

(1) Charitable gifts may need to be reported, and the charitable contribution information may be buried in the client's income tax workpapers;
(2) Prior year gift tax returns may need to be secured from prior preparer firms and made a part of the permanent file;
(3) Copies of trust agreements are necessary when gifts are made in trust;
(4) Appraisals of real estate and closely held business interests need to be obtained; and
(5) Client's attorney should be consulted regarding annual exclusions, withdrawal powers, and the advisability of allocating Generation Skipping Tax Exemptions.

The absence of any one or more of these items can tend to clog the tax preparation and review pipeline, at a time in March and April, when clients are more interested in getting business and individual returns filed than worrying about gift tax returns, so extensions can buy preparers a little more time and push the ultimate filing of such returns to the summer months.

All Good Extensions Come to an End

The extended due date for 2020 Gift Tax Returns of October 15, is rapidly approaching. August becomes an excellent time to refocus on our list of extended Gift Tax Returns lest we clog the September and October return due dates.

The Importance of Gift Tax Returns

The Gift Tax Return is in essence the taxpayer's estate planning scorecard. The return is important in not only reporting current taxable gifts, but it is also critical in keeping track of the taxpayer's utilization of not only the Gift and Estate Tax Applicable Credit Equivalent amount, but it also tracks the Deceased Spouse Unused Exclusion Amount (DSUE) and the Generation Skipping Tax (GST) Exemption Allocation.

The analogy that I employ when describing the role of the gift tax return is the Caribbean Limbo dance. The objective of the wealth transfer professional is to assist the client as they gently attempt to pass assets under the respective tax ("Limbo") bar without knocking that bar off of the vertical poles that hold it aloft. Each time assets are successfully passed under the respective tax bar, the remaining amounts of the Gift/Estate Tax Credit Equivalent, DSUE amount, or GST Exemption Allocation are adjusted (lowered) before the next transfer can be attempted.

Tracking this information is important to not only the taxpayer, but also the IRS, since the exhaustion of each Credit Equivalent, Exclusion Amount, or Exemption may result in the payment of a transfer tax.

Non-Filing or Late Filing of Gift Tax Returns

Code Sec. 6651 imposes penalties for both late filing and late payment of Gift Tax Returns; however, both penalties are computed based upon a percentage of the tax actually due. As a result, if the unreported gifts are not taxable in an amount in excess of the respective credits or exemptions, then no (dollar amount) penalty would practically be payable. Similarly, interest may also be assessed on any late payments of tax that are physically payable.

The detriment in non-filing or late filing lies therefore not in the penalty and interest provisions, but in the inability of the taxpayer to make various timely elections on the tax return. The election by the donor's spouse to "split gifts" under Code Sec. 2513 can only be made on the first gift tax return filed by either the donor or the donor's spouse, for the applicable year. Gift splitting cannot be elected by taxpayers after a notice of deficiency has been filed by the IRS.

The gift of a terminable interest in property to a spouse requires a general power of appointment in the spouse in order to automatically qualify for the unlimited marital deduction. In the absence of a general power of appointment, the donor must make a Qualified Terminable Interest Property (QTIP) election on IRS Form 709, Page 3, Part 4 by claiming the marital deduction for the terminable interest property.

The ability to "elect out of the automatic GST exemption allocation rules" (Code Sec. 2642(c)) similarly requires an election on the part of the donor in order preserve the unused GST exemption. This election is accomplished by checking the box in Column C on Form 709, Page 2, Schedule A and then attaching a statement describing the action of "electing out" of the automatic allocation rules.

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The Gift Tax Statute of Limitations

The IRS has three years after a gift tax return is filed in which to assess additional gift tax. The limitations period begins to run on the due date of the return, even if the gift tax return is filed early. The IRS has six-year period for assessment, if the amount of underreported gifts exceeds 25 percent of the total gifts reported in that calendar year. The U.S. Tax Court has held that once the Statute of Limitation has expired, the IRS is foreclosed from revaluing and assessing more gift tax under Code Sec. 2504(c), but the IRS is not prevented from revaluing the same transfer on the taxpayer's subsequent Form 706, U.S. Estate Tax Return or altering the amount of prior taxable gifts under Code Sec. 2001(b)(1)(B).[1] If the IRS adjusts prior taxable gifts at the time of death, the Tax Court in *Smith* determined that the IRS must similarly increase the amount of gift tax payable under Code Sec. 2001(b)(2) on the same transfers. The bottom line is that the adjustment does not increase the amount of tax due on the transferred item but it might push the assets of the gross estate at death into a higher percentage tax bracket.

A similar result was reached by the U.S. Tax Court relative to the application of the Deceased Spouse Unused Exemption (DSUE).[2] In *Sower*, the surviving spouse filed IRS Form 706 upon the death of her spouse and preserved the deceased spouse's unused credit equivalent amount. The Tax Court held that (1) even though the IRS issued an Estate Tax Closing Document (Letter 627) which showed no estate tax liability for the estate of the first spouse to die; and (2) the three-year Statute of Limitations for audit the IRS Form 706 of the first spouse to die had expired, nevertheless the IRS still had the right under Code Sec. 2010(c)(5)(B) to exam the values of the assets reflected on the deceased spouse's return and it could adjust down the amount of the DSUE available to the survivor.

The Gift Tax Return Checklist

Tax Return checklists may at times seem mundane. During the course of a tax season, we prepare countless individual income tax returns. If we were to follow a detailed checklist when completing each individual tax return, we might fall prey to mindlessly checking each of the boxes in an effort to rapidly complete the checklist and move on to other returns, rather than thoughtfully considering the implications of each query contained in the checklist.

During the course of a tax season, unless we have a large specialized tax preparation practice, individually, we might only complete a handful of significant gift tax returns. Our confidence level, while good, might be bolstered by a solid Gift Tax Checklist. As a member of the American Institute of Certified Public Accountants (AICPA) Tax Section, tax practitioners are eligible to download free annual tax return organizers, checklists, and sample engagement letters for a large assortment of returns, including IRS Form 709, U.S. Gift Tax Returns. Volunteer members of the AICPA Technical Review Panels go to great lengths to keep these practice aids current and relevant.

The AICPA Gift Tax Return Checklist assumes a level of familiarity with both the client and estate planning terminology that is designed for a preparer or reviewer with a minimum of three to five years of experience. The Checklist seeks to identify potential undisclosed transfers such as interest free or below-market loans and debt forgiveness issues, as well as sales for less than full and adequate consideration which the client may not have disclosed. The AICPA checklists are available in Word format and they are thus customizable for your firm's compliance practice needs. Consider using a checklist regardless of your level of experience.

Adequate Disclosure

There is no time limit (Statute of Limitations) on the assessment of tax on a gift that is either unreported or not adequately disclosed on a filed gift tax return. Reg. §301.6501(c)-1 describes the Adequate Disclosure requirements for incomplete gifts, non-gift completed transfers, and completed gifts. For completed gifts, the regulation requires either the return or an attachment to the return to provide the following information:

(1) A description of the property and any consideration that may have been received by the transferor in exchange for the property;
(2) The identity of both the transferor and the transferee;
(3) The familial relationship if any between the transferor and transferee;
(4) If the property is transferred in trust, the trust's tax identifying number, and a copy of the trust (or a brief description of the terms of the trust);
(5) A detailed description of the method used to determine the fair market value of the gift (a qualified appraisal will satisfy this requirement); and
(6) A statement describing any position taken contrary to any proposed, temporary, a final Treasury regulation, or any revenue rulings.

Where closely held business interests are transferred, a significant portion of these disclosure requirements are typically met in the valuation report prepared by a qualified appraiser. Nevertheless, the burden falls on the preparer to make sure that all of the disclosures are made.

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Check Boxes

IRS Form 709, Page 2, Schedule A, Item A asks "Does the value of any item listed on Schedule A reflect a valuation discount?" If the preparer omits checking one of the boxes, and thus neglects answering either "Yes" or "No," does that lack of an answer impact the Adequate Disclosure rules? Does that lack of disclosure undo the qualified appraiser's report which describes the computation of the valuation discount employed by the appraiser? Why leave this question to chance—check one of the boxes.

Donor's Adjusted Basis

IRS Form 709, Page 2, Schedule A, Column D requests the Adjusted Basis of the gifted property. At first blush, this amount would not appear to impact the fair market value of the gift or the computation of the gift tax, but it is relevant to the donee and the IRS. Under current rules, the Adjusted Basis of the gifted property in the hands of the donee is equal to the Donor's Adjusted Basis. The donee will need this basis information if they sell the gifted property at a later date.

The bottom line is that preparers of Gift Tax Returns should create checklists and check them twice in order to improve their chances of surviving an audit either now or many years later.

Conceivably, the IRS might argue that the Adjusted Basis of the Gift may be relevant to their potential evaluation of the fair market value of the gifted property. For example: Mallory gifts Blackacre to her daughter, Hattie. Blackacre is a piece of real estate that Mallory purchased last year at a cost of $200X. A qualified appraiser has prepared a valuation of the same real estate which was gifted six months later for a reported value of $100X. A full qualified appraisal is attached to the return. Is the appraisal enough to satisfy the Adequate Disclosure rules? Without Mallory's Adjusted Basis would a potential IRS Examiner be equally suspicious of the attached appraisal. Would the omission of that basis information be grounds of lack of Adequate Disclosure and the non-tolling of the Statute of Limitations? Why leave this question to chance—insert the tax basis.

In the income arena, we have seen an increased trend on the parts of both the IRS and the Tax Courts to crack down on reporting requirements that are contained in the Regulations. Each has adopted a strict construction of the disclosure requirements for income tax deductions of conservation easements and other large charitable gifts of property.

On January 16, 2013, the Treasury Inspector General for Tax Administration (TIGTA) reported a general lack of compliance by taxpayers with charitable gift reporting requirements associated with IRS Form 8283 and recommended corrective actions on the part of the IRS aimed at the disallowance of charitable contribution deductions for incomplete forms.[3] This effort led to a correspondence campaign and greater audit activity on the part of the Service.

Earlier this year, the Tax Court reinforced its lack of tolerance when it issued a memorandum decision in *L.J. Chiarelli*.[4] In *Chiarelli*, the taxpayer attached IRS Forms 8283 in an attempt support the claimed charitable contribution deductions, but in the Court's opinion "the taxpayer failed to make any reasonable attempt" to provide the information requested on the forms. This lax attempt at compliance was not tolerated by the Tax Court and the income tax charitable contribution deduction was disallowed.

Date of Gift

IRS Form 709, Page 2, Schedule A, Column E requests the date of the gift. Is this information critical for Adequate Disclosure purposes?

The date of the transfer is actually very important as the timing of a transfer may determine its eligibility for the Gift Tax Annual Exclusion and the GST Annual Exclusion. A gift made by the donor either before marriage or after the date of death of the spouse, may not be "split" by the donor's spouse for the purposes of Code Sec. 2513. In addition, the Gift Tax Annual Exclusion (Code Sec. 2503(b)) is only available to the first $15,000 gifted to a donee during the calendar year. Similarly, the GST Annual Exclusion of $15,000 is only available to a gift made to a "Skip Person" (*i.e.*, a grandchild or person more than 37½ younger than the transferor) that is "a non-taxable gift" (Code Sec. 2642) (*i.e.*, eligible for the Gift Tax Annual Exclusion (Code Sec. 2503) in the same year. Not respecting this chronological ordering of gifts can cause unintentional loss of GST Exemption.

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Let's look at two examples:

In the first example, Nancy makes $15,000 annual exclusion gifts to her grandchildren, and she also gifts cash to an irrevocable life insurance trust for the benefit of her children and grandchildren each year that contains withdrawal powers for her grandchildren. If she makes the outright cash gifts first, then the outright cash gifts will qualify for both the $15,000 Gift Tax Annual Exclusion and the $15,000 GST Annual Exclusion. The cash gifts to the life insurance trust will be future interest gifts and GST exemptions will need to be allocated to shield any GST implications.

In the second example, Nancy gifts cash to the life insurance trust first and the grandchildren outright second. The cash gifts to the life insurance trust containing withdrawal powers will qualify for the $15,000 Gift Tax Annual Exclusion, but since the insurance trust is for the benefit of multiple generations it is not deemed to be a "Direct Skip" (*i.e.*, a gift to a trust consisting only of Skip Persons as beneficiaries) eligible for the $15,000 GST Annual Exclusion. The cash gift later in the year will not qualify for the $15,000 Gift Tax Annual Exclusion, since the Gift Tax Annual Exclusion for each grandchild was previously applied to the earlier gifts to the insurance trust. Even though it would appear that the outright cash gifts, later in the year, might qualify as Direct Skips, they will not be eligible for the $15,000 GST Annual Exclusion because the same transfer does not simultaneously qualify for the $15,000 Gift Tax Annual Exclusion and the GST Annual Exclusion. The only way to shelter the cash gifts to the life insurance trust from GST will be to allocate GST Exemption to them.

Beware of Forming a False Sense of Security

The 2021 filing season will likely yield a large number of gift tax returns being filed with the IRS at a time when the Service lacks the manpower and the resources to adequately audit such returns. The likelihood of audit is low, but that should not provide comfort to either taxpayers or preparers.

President Biden has promised $80 billion of funding for the IRS over the next 10 years. In addition, progressives within the current Administration would like to free the IRS from the annual Congressional budget process. This attempt to unleash the IRS and give them the opportunity to modernize, if successful, will have long-term implications on tax administration.

Taxpayers and tax preparers alike should not be lured into a false sense of security if the gift tax returns are not be audited before 2024 (within the three-year Statute of Limitations). The examples of the IRS actions in the income tax arena suggest that the IRS has the Adequate Disclosure rules at its disposal, and the IRS will strictly enforce those rules. At the time that the estate tax return is filed years later, the IRS may choose at that time to review the all of the information being requested on IRS Form 709, looking for incomplete descriptions, failures to check boxes, supply dates, and Adequately Disclose Gifts in an effort to challenge these returns or in the alternative secure adjustments to the estate tax collected by adjusting the DSUE or increasing Adjusted Taxable Gifts.

The bottom line is that preparers of Gift Tax Returns should create checklists and check them twice in order to improve their chances of surviving an audit either now or many years later.

ENDNOTES

1 *F. Smith Est.*, 94 TC 872, Dec. 46,648 (1990).

2 *M.L. Sower Est.*, 149 TC 11 (2018).

3 *Many Taxpayers Are Still Not Complying with Noncash Charitable Contribution Reporting Requirements*, Treasury Inspector General for Tax Administration Report 2013-40-009 (Dec. 20, 2012).

4 *L.J. Chiarelli*, 121 TCM 118, Dec. 61,832(M), TC Memo. 2021-27.

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