Gift Tax Returns: Adequate Disclosure is Key

To best protect clients (and advisors), taxpayers must file gift tax returns disclosing both gifts and non-gifts.

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Can the Internal Revenue Service assert gift taxes 10, 20, 30 or 50 years later? You betcha, Red Ryder.

Many clients file no gift tax returns if they believe they owe no gift tax. More remarkable, many in the transactional world believe reorganizations or even related party sales don't require the parties to file gift tax returns. An advisor may argue that a transaction at fair market value (FMV) creates no gift, and a client may resist the elevated visibility of filing a gift tax return and disclosing a sale or reorganization. They tinker with oblivion because the IRS remains free forevermore to contend that a net gift occurred (regardless of intent), a gift tax return was due, a gift tax is due (plus interest, delinquency penalties and Internal Revenue Code Section 6662 penalties) and no adequate disclosure started the limitations period. Almost as bad, the client loses the opportunity to lock the IRS into the gift tax valuation under IRC Section 2001(f) when it comes time to calculate lifetime gifts on his estate tax return. To best protect clients (and advisors), taxpayers must file gift tax returns, adequately disclosing gifts and non-gifts.

The Taxman Cometh

Without adequate disclosure, the taxman may come calling decades later. The recent cases of *Estate of Redstone v. Commissioner*, 145 T.C. 259 (2015) and *Redstone v. Comm'r,* T.C. Memo. 2015-237 underscore why taxpayers must file returns even when they believe they owe no gift taxes. In the *Redstone* cases, the IRS argued that two brothers made gifts in 1972 when they transferred shares to their children pursuant to a reorganization. Because they filed no gift tax returns, the statute of limitations never started. That failure forced the brothers to argue that the transfer occurred in the ordinary course of business. The court found in favor of one brother, but determined that the other brother's transfer resulted in $737,625 of gift taxes. Through the end of 2015, interest would have increased the amount due to over $16

million. By failing to file a gift tax return, both brothers left the door open for the IRS to assert gift taxes decades later.

Gift Tax Regime

IRC Section 2501(a)imposes a tax "on the transfer of property by gift." IRC Section 2512(b) deems a gift to occur when a taxpayer transfers property for "less than adequate and full consideration in money or money's worth."IRC Section 2512(b) treats the excess value as an indirect gift. According to Treasury Regulations Section 25.2511-1(c), an indirect gift may occur in "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed." However, Treas. Regs. Section 25.2512-8 says a transaction made in the ordinary course of business "will be considered as made for an adequate and full consideration."

The Limitations Period Can Save You

IRC Section 6501 provides that, in general, "the amount of any tax imposed by this title shall be assessed within three years after the return was filed." Prior to 1990, a taxpayer needed to file a gift tax return to start the limitations period for non-gift transactions. In 1990, Congress amended Section 6501 and added the requirement that taxpayers adequately disclose gifts covered by the valuation rules of IRC Sections 2701 and 2702. In 1997, Congress again amended Section 6501(c)(9) to allow the IRS to assess gift taxes at any time for all gifts that taxpayers fail to report (Treas. Regs. Section 301.6501(c)-1(f)(1)). Section 6501(c)(9) says that the amended rule doesn't apply to "any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." Treasury Regulations Section 301.6501(c)-1(f)(1) refers to "apprising the secretary" as "adequate disclosure."

Treas. Regs. Section 301.6501(c)-1(f)(2) provides detailed instructions on what qualifies as adequate disclosure. Typically, a taxpayer must disclose: 1) a description of the transferred property and any consideration received; 2) the identity of, and

relationship between, the transferor and each transferee; 3) if the property is transferred in trust, the trust's identification number and a description of the trust's terms; 4) a detailed description of the method used to value the transferred property; and 5) a statement describing any position taken that contradicts any regulation or IRS position. It notes that a qualified appraisal generally "adequately discloses" the required valuation details. To qualify, the appraisal must be completed by a commercial appraiser with appropriate qualifications. The appraisal must include the date of the transfer, the purpose of the appraisal, a description of the property, a description of the appraisal process, a description of any assumptions or conditions, a list of information relied on, the appraisal procedures followed and the reasoning that supports the analysis, the valuation method utilized and the specific basis for the valuation. By disclosing non-gift transactions in accordance with Treas. Regs. Section 301.6501(c)-1(f), a taxpayer will start the limitations period and limit the time for the IRS to start an audit.

If The IRS Comes Calling

Adequately disclosing the non-taxable gifts according to the guidelines found in Section 6501(c)(9) and Treas. Regs. Section 301.6501(c)-1(f) remains the best way to stop a latent IRS audit from starting. But what do you do if the IRS starts digging decades after the fact?

Your client should first argue that the transfer didn't create a gift because the parties exchanged their interests for FMV. A still breathing taxpayer, the CFO and their CPA remain the best source of information about value. Your clients should keep all transaction documents and appraisals for the life of the entities to combat any latent IRS challenges. Remember that the estate tax return includes life time gifts and the IRS Estate & Gift Tax Attorney will ask for the stock ledger book – the corporate equivalent of a family Bible.

Your client can also argue that the transfer occurred in the ordinary course of a trade or business. Treas. Regs. Section 25.2512-8 casts those transfers as non-gifts. To qualify, the transaction must be bona-fide, at arm's length and free from any

donative intent. A transfer in the ordinary course of business won't constitute a gift, even if one party later concludes that he did not receive fair value. (Estate of Redstone, 145 T.C. at 269).

While the IRS closely scrutinizes intra-family transactions, Treas. Regs. Section 301.6501(c)-1(f)(4) treats intra-family transactions made in the ordinary course of business and consistently reported on income tax returns as adequately disclosed for gift tax purposes. Regardless of the strategy chosen, adequate disclosure remains the best way to protect our future against our past.

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