

Problems Created by New Prop. Regs. on Revaluation of Gifts

A gift must be adequately disclosed on a gift tax return in order to begin the running of the statute of limitations and to prevent revaluation of the gift. New Proposed Regs. interpret the 'adequate disclosure' requirement very stringently.

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Changes to the Internal Revenue Code made by TRA '97 and the Internal Revenue Restructuring and Reform Act of 1998 ('98 Act) were designed to prevent the IRS from revaluing lifetime taxable transfers for estate tax purposes after the statute of limitations for assessing gift tax had expired. In a series of cases, starting in 1990, the Tax Court, the Fourth and Eighth Circuits, and a district court¹ held that, even though the period for assessing gift tax had expired, the gift could nevertheless be revalued for estate tax purposes.

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es. The effect of these decisions was to allow inclusion in the gross estate of the excess of the fair market value (FMV) of the gift over the amount reported on the gift tax return.

Chapter 14 valuation rules

For gifts made after 10/8/90, the three-year gift tax statute of limitations is suspended indefinitely if the gifts are valued under the Section 2701-2702 valuation rules or there is any increase in taxable gifts under Section 2701(d), unless disclosure on the gift tax return—or in a statement attached to the return—is made in a manner to apprise the IRS of the nature of each gift.² The requirements for adequate disclosure are:³

1. A description of the transaction, including both the transferred and retained interests;
2. Identification of all persons involved and their relationship to the donor, as well as all persons related to the donor who hold an equity

interest in the entity involved in the transaction;

3. A detailed description of valuation methods used (including actuarial factors, discount rates, and financial data generally); and
4. Attachment of financial statements of the entity for each of the five preceding years.

1997 and 1998 Act changes

Under the 1997 and 1998 changes, the IRS may no longer revalue gifts—whether or not gift tax was paid—if the statute of limitations has expired, provided the donor satisfies the adequate disclosure requirement now applicable to all gifts made after 8/5/97. Conversely, if the donor does not satisfy this adequate disclosure requirement, the statute of limitations does not run, leaving the transferor (or his or her estate) exposed to a possible revaluation of the gift and the resulting increased transfer tax costs.⁴

The statutory requirements

The statutory parameters for adequate disclosure are that the value of the gift must be disclosed on a timely filed gift tax return or in a statement attached to the return in a manner to adequately apprise the IRS of the nature of the gift.⁵ If there is adequate disclosure, and the three-year statute of limitations has expired, then the value of the gift is the value as finally determined.⁶ The '98 Act clarified that "value as finally determined" means:⁷

- The value reported on the gift tax return (or on a statement attached to the return), provided the IRS does not contest the value before the expiration of the statute of limitations;
- The value as determined by the IRS if not challenged by the donor;
- The value as fixed by the court; or
- The value agreed to by the donor and the IRS in a settlement.

Proposed Regulations are onerous

The IRS recently issued Proposed Regulations⁸ implementing its understanding of the adequate disclosure requirement. Although the Proposed Regulations provide guidance, they are not free of what could be costly tax traps, especially when the property that is the subject of the gift is hard to value.

The donor's burden of adequate disclosure. The Proposed Regulations contain a list of information that must be reported on the gift tax return or in an attached statement in order for the transaction to be considered adequately disclosed so as to cause the period for assessment to commence. The

required information, which many practitioners will consider onerous, must include the following:⁹

1. A description of the transferred property, including any consideration received by the transferor.
2. The identity of, and relationship between, the transferor and the transferee.
3. A detailed description of the method used to determine FMV, including relevant financial data and discounts (such as discounts for blockage, minority or fractional interests, and lack of marketability). If the transfer consists of an interest in an entity that is not actively traded, the disclosure must describe not only any discounts taken in valuing the entity but also any discounts claimed in valuing any assets owned by the entity, including a statement as to the FMV of 100% of the entity (without regard to any discounts in valuing the entity or any of its assets), the pro rata portion of the entity subject to the transfer, and the FMV of the transferred interest as reported on the gift tax return. These requirements also extend to non-actively traded entities owned by the entity directly or indirectly through another entity.
4. If the transfer is in trust, the trust's tax identification number and a brief description of the terms of the trust.
5. Any restrictions on the transferred property that were considered in determining its FMV.
6. A statement of the relevant facts affecting the gift tax treatment of the transfer that may reasonably be expected

to apprise the IRS of the nature of any potential controversy concerning the gift tax treatment, or in lieu of this statement, a concise description of the legal issue presented by the facts. Additionally, a statement must be submitted describing any position taken that is contrary to any Temporary or final Regulations or Revenue Rulings.

Impact of the Proposed Regulations

Items 3, 5, and 6 (above) of the Proposed Regulations literally require the donor to establish his or her position as one would be required to do in a court case. This goes beyond the statutory requirement of adequate disclosure, which states merely that the IRS must be adequately apprised of the nature of the gift. The statute does not say that the donor must establish that the valuation used is proper.

Once apprised of the nature of the gift, the IRS can always request additional information. The IRS will be adequately apprised by a simplified disclosure that indicates: (1) whether there is a public market for the asset, (2) whether any discounts were taken in arriving at FMV, and (3) whether an appraisal was used to determine FMV.

¹ See *Estate of Smith*, 94 TC 372 (1990), *acq.*; *Estate of Lennett*, TCM 1990-403; *Estate of Prince*, TCM 1991-208; *aff'd sub nom Levin*, 166 F.2d 311, 11 AFTR2d 33-2161 (CA-4, 1993); *Stalick*, 192 F. Supp. 114, 68 AFTR2d 31-6057 (DC D.C., 1991); and *Evanson*, 30 F.3d 960, 14 AFTR2d 94-7459 (CA-6, 1994).

² Section 6501(c)(9).

³ Reg. 301.6501-1(c).

⁴ Sections 2001-11, 2504(c), 6501(c)(9), and 1217.

⁵ Sections 2001-11 and 6501(c)(9).

⁶ Section 2504(c).

⁷ Section 2001-11(f)(2), Prop. Regs. 20.2001-11(a) and 20.2001-11(c).

⁸ REG-106177-98 12/21/98.

⁹ Prop. Reg. 301.6501(c)-1(f)(2).

A disclosure of items (1) and (2) (in the preceding paragraph) should be sufficient to prompt a reaction from the IRS that further review may be necessary. The existence of an appraisal should provide more extensive information to enlighten the IRS, while the absence of an appraisal should be the trigger for requesting all the additional information required by the Proposed Regulation.

The Proposed Regulations contain numerous tax traps. So much detailed information is required that it is unlikely donors could ever comply fully. This leaves donors open to a claim by the IRS that there was inadequate disclosure

and that the statute of limitations never ran.

The following example (with editorial changes), which appears in the Proposed Regulations, shows that the IRS intends to take a strict position on adequate disclosure.¹⁰

Example. Adam owns a 70% limited partnership interest in LTD, which in turn owns 40% of the stock of Widget Corp., a closely held corporation. The assets of Widget include a 50% general partnership interest in GP. GP owns an interest in commercial real property. None of the entities (LTD, Widget, or GP) are actively traded.

In 1999, Adam transfers a 25% limited partnership interest in LTD to his daughter, Mary. His 1999

gift tax return shows that 100% of LTD is valued at \$Y and that the value of the 25% interest transferred to Mary is \$Z, reflecting lack of marketability and minority interest discounts. The gift tax return, however, does not disclose that LTD owns 40% of Widget, which in turn owns 50% of GP, and that—in arriving at the \$Y FMV of 100% of LTD—discounts were claimed in valuing LTD's interest in Widget, and Widget's interest in GP, and GP's interest in the commercial real property.

Because of Adam's failure to disclose the omitted information, the IRS concluded that Adam failed to adequately disclose the transaction on his gift tax return. Accordingly, the assessment period will remain open indefinitely.

¹⁰ Prop. Reg. 301.6501(c)-1(f)(5), Example 4

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Although this conclusion is correct under the Proposed Regulations, it is not correct with respect to the issue of what constitutes adequate disclosure.

Adam disclosed more than enough information for the IRS to determine that the transaction should be reviewed. He disclosed that he transferred hard-to-value assets to his daughter and that their valuation was based on minority and lack of marketability discounts. Those two factors alone should be sufficient to alert the IRS and should therefore constitute adequate disclosure.

In addition, Adam may not have access to all the information required by the IRS. The example in the Proposed Regulations states that Adam is only a limited partner in LTD. A limited partner is passive and has no management function. The general partner has sole control of the limited partnership. Further, LTD holds only a minority (40%) interest in Widget, and Widget holds a minority (50%) interest in GP. Adam may not know the percentage interest that GP holds in the commercial real estate.

The IRS' example will create havoc for taxpayers who are in a position similar to that of Adam. Even if he controlled all the entities, the information demanded is unnecessary. To be alerted to a possible valuation issue, the IRS needs to know only that (1) there is no market for the asset and (2)

discounts have been taken in arriving at the value.

Issues other than valuation. The Proposed Regulations make it clear that the ban on revaluations of gifts does not apply to issues other than value.¹¹ This means, for example, that even though the IRS may not be able to revalue the transfer, it may still attack the transfer on other grounds, such as the use of Crummey withdrawal rights to create annual exclusion gifts.

Incomplete transfers. If the transfer is reported as a completed gift on the gift tax return—and if the adequate disclosure requirement is met—the running of the statutory assessment period bars the IRS from revaluing the transfer, even if the Service later establishes that the gift was incomplete. On the other hand, if the transfer was reported as an incomplete gift, the statute of limitations does not run, even if there is adequate disclosure, until the transfer is reported as a completed gift.¹²

Gifts made prior to 8/6/97. Prior to TRA '97 and the '98 Act (except for transfers under Sections 2701 and 2702), if gift tax had been paid or assessed with respect to the calendar period in which the gift occurred, and the statute of limitations had expired, then the value of the gift could not be adjusted for gift tax purposes. This rule

Practice Notes

The Proposed Regulations on adequate disclosure of gifts impose burdensome information demands on donors. So much detailed information is required that it is unlikely donors could ever comply fully. This leaves them open to a claim by the IRS that disclosure was inadequate and that the statute of limitations never ran.

continues to apply for gifts made prior to 8/6/97. For estate tax purposes, though, transfers prior to 8/6/97 may continue to be revalued even if gift tax was paid or assessed for the prior calendar period.¹³

Conclusion

The preamble to the Proposed Regulations states that the information required to satisfy the adequate disclosure requirement "is intended to enable the IRS to identify issues, if any, without imposing an undue burden on taxpayers." Because of the burdensome information demands in the Proposed Regulations, the IRS has failed to achieve this goal. ■

¹¹ Prop. Regs. 20.2001-1(b) and 20.2001-1(f), Example 2

¹² Prop. Reg. 301.6501(c)-1(f)(4)

¹³ Prop. Regs. 20.2001-1(a) and 25.2504-2(a)