NEW JERSEY SOCIETY OF CPAS
MORRIS/SUSSEX CHAPTER
ANNUAL TAX SEMINAR

GIFT TAX RETURNS

November 13, 2009

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I. CAVEAT

Any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code, or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

II. INTRODUCTION

The 1976 Tax Reform Act unified the estate and gift tax rates and credit.

The 1981 Economic Recovery Tax Act increased the annual gift tax exclusion to $10,000, and provided that direct payments to providers for qualified educational expenses and medical expenses are not treated as gifts.

The Taxpayer Relief Act of 1997 added the provision providing for annual inflation adjustments to the annual gift tax exclusion, which was then $10,000 and for 2009 is $13,000.

The 2001 Economic Growth and Tax Relief Reconciliation Act (2001 Tax Relief Act) reduced the estate, gift, and generation-skipping transfer tax ("GST tax") rates, increased the estate tax and GST tax exemption amounts, and decoupled the lifetime gift tax exemption and the estate tax exemptions so that the gift tax exemption remained at $1 million. The gift tax exemption was left at $1 million because when the 2001 Act provisions sunset on December 31, 2010, the estate tax exemption as of January 1, 2011 will return to $1 million.

Form 709 has been revised periodically:

- Gifts made before 1982: November 1981 revision.
- Gifts made after 1981 and before 1987: January 1987 revision.
- Gifts made after 1986 and before 1989: December 1988 revision.
- Gifts made after 1988 and before 1990: December 1989 revision.
- Gifts made after 1989 and before October 9, 1990: October 1990 revision.
- Gifts made after October 8, 1990 and before 1993: November 1991 revision.
- Gifts made after 1992 and before 1996: November 1993 revision.
- Gifts made after 1995 and before 1998: December 1996 revision.

- Beginning with calendar year 1998, the IRS has revised the Form 709 on an annual basis. Thus, the preparer should use the version of Form 709 that is specifically designated for the calendar year in which the gift is made.

III. WHO, WHAT, WHEN AND WHERE

A. WHO MUST FILE

The gift tax return is filed by the donor. If the donor dies before filing the return, the donor's executor files it. If the donor becomes incompetent, the Attorney-in-Fact under a Power of Attorney specifically authorizing the Attorney-In-Fact to file returns, or the donor's legal guardian files the return.

B. WHAT GIFTS REQUIRE FILING

A gift tax return must be filed when there are gifts of:

(1) future interests;

(2) present interests that exceed the annual gift tax exclusion (currently $13,000). Note that if a gift exceeds the annual exclusion amount, a gift tax return must be filed even if the spouses are splitting the gifts and the gift does not exceed the two combined annual exclusion amounts;

(3) to a non-U.S. citizen spouse if the gift exceeds that annual exclusion (Internal Revenue Code §2523(i), currently $130,000 adjusted for inflation after 1998);

(4) qualified terminable interest property since if a QTIP election is being made, it must be done on a timely filed gift tax return (Internal Revenue Code §2523(f));

(5) split gifts with a spouse (Internal Revenue Code §2513);

(6) partial interest gifts to charities (e.g. charitable remainder trusts, charitable lead trusts, charitable gift annuities, or pooled income fund. (Internal Revenue Code §6019(3)); and

(7) to make a non-deemed allocation of Generation Skipping Transfer Tax exemption under Internal Revenue Code §2632(c)(5))B) sort of, the GSTT exemption allocation is discussed in more detail below.

C. WHEN TO FILE

General rule: The gift tax return is due on the same date as the individual's income tax return for the year in which the gift was made (i.e. April 15 of the following year or the extended date for those in combat and contingency zones).

Acceleration: However, if the donor dies during the year that reportable gifts are made, the gift tax return is due *on the earlier of* April 15 of the following calendar year or the due date of the Federal Estate Tax Return. Internal Revenue Code §6075(b)(3).

Extensions: As with income tax returns and estate tax returns, extensions of time to file are not extensions of time to pay. If a gift tax is due and an extension is sought, you must file Form 8892, Payment of Gift/GST Tax and/or Application for Automatic Extension of Time to File Form 709.

(1) A valid 6 month extension to file an income tax return by filing Form 4868 automatically gives a 6 month extension to file the gift tax return.

(2) A 6 month automatic extension of time to file a gift tax return may be obtained even when there is no income tax extension by filing Form 8892 on or before the due date of the gift tax return.

(3) If the donor died in the year of the gift and the gift tax return is due at the same time as the Federal estate tax return, then a valid 6 month extension to file the estate tax return by filing Form 4768 automatically gives a 6 month extension to file the gift tax return.

Any tax due is payable upon the due date without regard to any extension of time for filing the return.

D. WHERE TO FILE

Internal Revenue Service Center, Cincinnati, Ohio 45999.

IV. HOW TO FILE

A copy of Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (For gifts made during calendar year 2008) is attached and was used in preparing the following materials. The 2009 version was not released as of the date these materials were prepared. The "pending" release date is November 17, 2009 (even though the return due date will already have passed for donor's dying between January 1, 2009 and February 16, 2009).

A. Part I, Line 8 If donor died

If the donor died during the year, check the box and enter the donor's date of death. **Remember this changes the due date of the gift tax return.**

B. Part I, Line 9 Extensions

If the return has been extended, do not forget to check the box and attach Form 4868 if extended by extending the donor's income tax return, Form 8892 if a separate gift tax extension was filed, or Form 4768 if the donor died during the year of gift and the gift tax return was extending by extending the estate tax return.

C. Part I, Line 10 Number of donees

If you are using gift tax return preparation software you need to manually check the number of donees. Gift tax return preparation software may not get this number right. How transfers to trusts, crummy withdrawal rights and other gifts are disclosed may cause the software to calculate an incorrect number of donees. If it does, it will also result in an incorrect calculation of annual exclusions. Be aware that you may need to override this field.

D. Part I, Lines 12 to 18 Split Gifts

A donor may elect to split gifts with his or her spouse for both gift tax and GST tax purposes. The election treats all gifts by the spouses or either of them as made one-half by each of them, effectively doubling the annual exclusion. Gift splitting is "all or nothing." If gift splitting is elected it applies to all gifts, except gifts from one spouse to the other.

The election is not always available. It is not available:

(1) Same sex couples. While New Jersey and some other states recognize same sex couples as having "marital" rights, under the federal Defense of Marriage Act (enacted in 1996 and defining marriage as between one man and one woman for purposes of all federal laws) these relationships are not recognized under federal law and such couples cannot elect to split gifts.

(2) The election is also not available if either spouse is a nonresident alien at the time of the gift. Internal Revenue Code §2513(a)(1).

The election is available if the spouses divorce during the year or one or both spouses die during the year, provided that (1) they were married on the date the gifts were made, and (2) neither spouse (or the surviving spouse) remarried before the end of the year. Internal Revenue Code

§2513(a)(2).

The election must be made on the gift tax return for the period. The election is made on the first gift tax return filed for the period of the gift, even if it is a late filed return, provided that (1) neither spouse filed a prior gift tax return, and (2) a gift tax notice of deficiency has not been issued by the IRS with respect to the tax period for that taxpayer or his or her spouse.

The right to revoke a consent to split gifts effectively ends on April 15 of the year following the year the gift was made. In other words, there is no right to revoke a consent given after that date.

Only one gift tax return may be filed, if:

(1) only the spouse filing the return made any gifts in excess of the annual gift tax exclusion, except the donor's spouse may have made gifts in excess of the annual exclusion to donees to whom the donor spouse also made gifts;

(2) none of the donees received total gifts from the donor and donor's spouse exceeding two times the annual gift tax exclusion; and

(3) all the gifts were of a present interest.

By making the election, the spouses agree to joint and several liability for any gift tax liability arising from the return.

Example: In February 2009, Husband makes a $20,000 contribution to an irrevocable life insurance trust and wife makes a $15,000 gift to each of their two children and $15,000 to her niece. Wife has a $10,000 crummey withdrawal right over the contribution to the trust and each child has a $5,000 withdrawal right. In December 2009 they divorce. Husband remarries in January 2010 and wife remarries in December 2010.

Are they eligible to split gifts for 2009? Yes. They were married to each other at the time the gifts were made and neither remarried in 2009.

Can they file one return? Yes, all of the gifts are under the combined annual gift tax exclusions, but it must be wife's return because of the gift to the wife's niece, and all gifts were of a present interest because of the crummy withdrawal rights. If husband had given a gift to the niece of anywhere from $1 to $11,000 (or 2 times gift tax exemption minus $15,000), then either spouse could file the return and the other could consent.

Note that if husband wishes to disclose the gift to the Irrevocable Life Insurance Trust, he must file a separate return since the gift from the husband to the wife is not split and therefore not reported on her return.

Why wouldn't spouses elect to split gifts? A few examples: they may be planning for divorce and do not want joint and several liability or just hate each others guts and won't sign the same piece of paper, have different beneficiaries in mind, be in a second marriage where each plans to eventually leave their assets to their own children and splitting gifts will use some of their lifetime gift tax exemptions, where estate sizes are unequal and using some of the non-donor spouse's lifetime gift tax exemption will have a disparate result, where spouses have an unequal amount of lifetime gift tax

exemption remaining.

Additionally, taxpayers electing to split gifts must consider the GST tax when reporting the gifts. To avoid automatic allocation rules, discussed below, each spouse must file a gift tax return.

E. Schedule A, Line A, Valuation Discount

While it may be stating the obvious, if a valuation discount is claimed for any gifts reported on the gift tax return, you need to check the box. Also stating the obvious, checking the box flags the gift tax return for review by the IRS and increases the chance of an audit. The discount needs to be supported by a written statement attached to the gift tax return showing the amount of the discount and the basis for the discount. Usually, the discount is determined by an appraisal. Attaching the appraiser's report to the gift tax return helps to avoid an audit in the absence of other issues.

Failing to check the box or attach the appropriate statements will probably result in the gift being deemed inadequately disclosed so that the statute of limitations will not run on the value of the gift, the gift tax liability and the remaining federal estate tax exemption available on the donor's federal estate tax return. The adequate disclosure rules are discussed below.

F. Schedule A, Line B, IRC §529, Qualified State Tuition Plans

Schedule A also contains a box that must be checked if the donor is electing to treat a contribution to a Internal Revenue Code §529 Qualified State Tuition Plan as made ratably over five years, beginning with the year of the gift. A discussion of Internal Revenue Code §529 Qualified State Tuition Plans is beyond the scope of this presentation. If the donor made a contribution to an Internal Revenue Code §529 Qualified State Tuition Plan that exceed the annual gift tax exclusion amount, the donor can treat the gift as made ratably over 5 years. To make the election, check the box and attach a statement that includes: (1) the name of each beneficiary for whom a contribution was made; (2) the amount contributed for each beneficiary; and (3) the amount for which the election is being made

This may not always be advantageous, since if the donor dies within that 5 year period, contributions deemed made in the years after the year of donor's death are pulled back into the donor's estate for federal, and, therefore New Jersey, estate tax purposes. For example, if grandfather put $20,000 into an Internal Revenue Code §529 Qualified State Tuition Plan for granddaughter, and makes the election, grandfather is deemed to make 5 annual $4,000 gifts to granddaughter. If grandfather dies 3 years after the gift is made, $8,000 (the gifts for years 4 and 5) is pulled back into his estate. **Making the 5 year election could unnecessarily cause an increase in New Jersey estate tax where there may be no federal taxable estate, and therefore, use of the federal lifetime gift tax exemption and the reduction in available federal estate tax exemption may be irrelevant.**

The election applies only to the annual gift tax exclusion amount. If the gift to the Internal Revenue Code §529 Qualified State Tuition Plan exceeds 5 times the annual gift tax exclusion, and the

election is made to treat the gift as made ratably over 5 years, the excess is a taxable gift in the year of the contribution. Example: grandfather puts $66,000 into an Internal Revenue Code §529 Qualified State Tuition Plan for his granddaughter in 2009. The annual gift tax exclusion is $13,000. 5 times the annual gift tax exclusion is $65,000. The election would apply to $65,000 and $1,000 would be a taxable gift in 2009 or use some of grandfather's lifetime gift tax exemption.

Subsequent gift tax returns. If the donor makes no reportable gifts in the next 4 years, then no gift tax returns are required because of the Internal Revenue Code §529 Qualified State Tuition Plan contribution being treated as made in those years. For each of the 4 subsequent years, if a gift tax return is filed the Internal Revenue Code §529 Qualified State Tuition Plan contribution deemed made in that year should be reported on that return.

We need to advise clients making annual gifts to remember to take the deemed contributions in future years into account so hat they do not inadvertently exceed the annual gift tax limit. For example, if the grandfather in the above example gives granddaughter $10,000 in 2010, that plus the $4,000 Internal Revenue Code §529 Qualified State Tuition Plan contribution deemed made in 2010 puts him over the annual gift tax exclusion.

G. Schedule A, Listing the Gifts - Adequate Disclosure

The gift tax return must adequately disclose the donor's gifts. The penalty for failing to make adequate disclosure is that the statute of limitations will not run on the value of the gift, the gift tax liability and the remaining federal estate tax exemption available on the donor's federal estate tax return.

The rules for adequate disclosure are set forth in Treasury Regulation §301.6501(c)-1(f) Exceptions To General Period Of Limitations On Assessment And Collection, Gifts Made After December 31, 1996, Not Adequately Disclosed On The Return [emphasis added at certain points]:

301.6501(c)-1(f)(1) In General. If a transfer of property, other than a transfer described in paragraph (e) of this section, is not adequately disclosed on a gift tax return (Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return"), or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax imposed by chapter 12 of subtitle B of the Internal Revenue Code on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.

(2) Adequate Disclosure Of Transfers Of Property Reported As Gifts. A transfer will be adequately disclosed on the return only if it is **reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported**. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information-

(i) A **description of the transferred property** and any consideration received by the transferor;

(ii) **The identity of, and relationship between, the transferor and each transferee**;

(iii) 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**;

(iv) Except as provided in Section 301.6501-1(f)(3), **a detailed description of the method used to determine the fair market value of property transferred**, including any financial data (for example, balance sheets, etc. with explanations of any adjustments)that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph(f)(2)(iv). **In the case of the transfer of an interest in an entity(for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, 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, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest**; and

(v) 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** (see Section 601.601(d)(2)of this chapter).

(3) **Submission Of Appraisals In Lieu Of The Information Required Under Paragraph (F)(2)(iv)** Of This Section. The requirements of paragraph (f)(2)(iv) of this section will be satisfied if

the donor submits an appraisal of the transferred property that meets the following requirements--

(i) The appraisal is prepared by an **appraiser who satisfies all of the following requirements:**

(A) The appraiser is an individual who **holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis**.

(B) **Because of** the appraiser's **qualifications**, as **described in the appraisal that details the appraiser's background, experience, education, and membership**, if any, **in professional appraisal associations**, the appraiser is **qualified to make appraisals of the type of property being valued**.

(C) The **appraiser is not the donor or the donee of the property or a member of the family of the donor or donee**, as defined in section 2032A(e)(2), **or any person employed by the donor, the donee, or a member of the family of either**; and

(ii) **The appraisal contains <u>all</u> of the following:**

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

(G) The valuation method utilized the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition

transactions, etc.

(4) Adequate Disclosure Of Non-Gift Completed Transfers Or Transactions. Completed transfers **to members of the transferor's family**, as defined in section 2032A(e)(2), that are **made in the ordinary course of operating a business** are deemed to be **adequately disclosed** under paragraph (f)(2) of this section, even if the transfer is not reported on a gift tax return, provided the transfer is **properly reported by all parties for income tax purposes**. For example, in the case of salary paid to a family member employed in a family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. For purposes of this paragraph (f)(4), **any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed** under paragraph (f)(2) of this section **only if the following information is provided on, or attached to, the return**--

(i) The information **required for adequate disclosure under paragraphs (f)(2)(i), (ii), (iii) and (v) of this section**; and

(ii) An explanation **as to why the transfer is not a transfer by gift** under chapter 12 of the Internal Revenue Code.

(5) Adequate Disclosure Of Incomplete Transfers. Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift for purposes of Section 25.2511-2 of this chapter. For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as determined under section 6501(b). Further, once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included. On the other hand, if the transfer is reported as an incomplete gift whether or not adequately disclosed, the period for assessing a gift tax with respect to the transfer will not commence to run even if the transfer is ultimately determined to be a completed gift. In that situation, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

(6) Treatment Of **Split Gifts**. If a husband and wife elect under section 2513 to treat a gift made to a third party as made one-half by each spouse, the requirements of this paragraph (f) will be **satisfied with respect to the** gift deemed made by the **consenting spouse if the return filed by the donor spouse** (the spouse that transferred the property) **satisfies the requirements of this paragraph (f)** with respect to that gift.

(7) Examples. The following examples illustrate the rules of this paragraph (f):

Example 1. (i) Facts. In 2001, A transfers 100 shares of common stock of XYZ Corporation to A's child. The common stock of XYZ Corporation is actively traded on a major stock

exchange. For gift tax purposes, the fair market value of one share of XYZ common stock on the date of the transfer, determined in accordance with Section 25.2512-2(b) of this chapter (based on the mean between the highest and lowest quoted selling prices), is $150.00. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A reports the gift to A's child of 100 shares of common stock of XYZ Corporation with a value for gift tax purposes of $15,000. A specifies the date of the transfer, recites that the stock is publicly traded, identifies the stock exchange on which the stock is traded, lists the stock's CUSIP number, and lists the mean between the highest and lowest quoted selling prices for the date of transfer.

(ii) Application of the adequate disclosure standard. A has adequately disclosed the transfer. Therefore, the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

Example 2. (i) Facts. On December 30, 2001, A transfers closely-held stock to B, A's child. A determined that the value of the transferred stock, on December 30, 2001, was $9,000. A made no other transfers to B, or any other donee, during 2001. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information required under paragraph (f)(2) of this section such that the transfer is adequately disclosed. A claims an annual exclusion under section 2503(b) for the transfer.

(ii) Application of the adequate disclosure standard. Because the transfer is adequately disclosed under paragraph (f)(2) of this section, the period of assessment for the transfer will expire as prescribed by section 6501(b), notwithstanding that if A's valuation of the closely-held stock was correct, A was not required to file a gift tax return reporting the transfer under section 6019. After the period of assessment has expired on the transfer, the Internal Revenue Service is precluded from redetermining the amount of the gift for purposes of assessing gift tax or for purposes of determining the estate tax liability. Therefore, the amount of the gift as reported on A's 2001 Federal gift tax return may not be redetermined for purposes of determining A's prior taxable gifts (for gift tax purposes) or A's adjusted taxable gifts (for estate tax purposes).

Example 3. (i) Facts. A owns 100 percent of the common stock of X, a closely-held corporation. X does not hold an interest in any other entity that is not actively traded. In 2001, A transfers 20 percent of the X stock to B and C, A's children, in a transfer that is not subject to the special valuation rules of section 2701. The transfer is made outright with no restrictions on ownership rights, including voting rights and the right to transfer the stock. Based on generally applicable valuation principles, the value of X would be determined based on the net value of the assets owned by X. The reported value of the transferred stock incorporates the use of minority discounts and lack of marketability discounts. No other discounts were used in arriving at the fair market value of the transferred stock or any assets owned by X. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information required under paragraph (f)(2) of this section including a statement reporting the fair market value of 100 percent of X (before taking into account any discounts), the pro rata portion of X subject to the transfer, and the reported value of the transfer. A also attaches a statement regarding the determination of value that includes a discussion of the

discounts claimed and how the discounts were determined.

(ii) Application of the adequate disclosure standard. A has provided sufficient information such that the transfer will be considered adequately disclosed and the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

Example 4. (i) Facts. A owns a 70 percent limited partnership interest in PS. PS owns 40 percent of the stock in X, a closely-held corporation. The assets of X include a 50 percent general partnership interest in PB. PB owns an interest in commercial real property. None of the entities (PS, X, or PB) is actively traded and, based on generally applicable valuation principles, the value of each entity would be determined based on the net value of the assets owned by each entity. In 2001, A transfers a 25 percent limited partnership interest in PS to B, A's child. On the Federal gift tax return, Form 709, for the 2001 calendar year, A reports the transfer of the 25 percent limited partnership interest in PS and that the fair market value of 100 percent of PS is $y and that the value of 25 percent of PS is $z, reflecting marketability and minority discounts with respect to the 25 percent interest. However, A does not disclose that PS owns 40 percent of X, and that X owns 50 percent of PB and that, in arriving at the $y fair market value of 100 percent of PS, discounts were claimed in valuing PS's interest in X, X's interest in PB, and PB's interest in the commercial real property.

(ii) Application of the adequate disclosure standard. The information on the lower tiered entities is relevant and material in determining the value of the transferred interest in PS. Accordingly, because A has failed to comply with requirements of paragraph (f)(2)(iv) of this section regarding PS's interest in X, X's interest in PB, and PB's interest in the commercial real property, the transfer will not be considered adequately disclosed and the period of assessment for the transfer under section 6501 will remain open indefinitely.

Example 5. The facts are the same as in Example 4 except that A submits, with the Federal tax return, an appraisal of the 25 percent limited partnership interest in PS that satisfies the requirements of paragraph (f)(3) of this section in lieu of the information required in paragraph (f)(2)(iv) of this section. Assuming the other requirements of paragraph (f)(2) of this section are satisfied, the transfer is considered adequately disclosed and the period for assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b) of this chapter).

Example 6. A owns 100 percent of the stock of X Corporation, a company actively engaged in a manufacturing business. B, A's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. B reports the annual salary as income on B's income tax returns. In 2001, A transfers property to family members and files a Federal gift tax return reporting the transfers. However, A does not disclose the 2001 salary payments made to B. Because the salary payments were reported as income on B's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to B, reported on the gift tax return must satisfy the adequate disclosure requirements under paragraph (f)(2) of this section in order for the period of assessment under section 6501 to commence to run with

respect to those transfers.

(8) Effective Date. This paragraph (f) is applicable to gifts made after December 31, 1996, for which the gift tax return for such calendar year is filed after December 3, 1999.

H. Schedule A, Part 2, Direct Skips

A brief background on the Generation Skipping Transfer Tax: This tax is imposed if the donor gives assets to grandchildren (or people who are deemed to be two or more generations younger than you) when the grandchild's parent who is the donor's child is alive. The tax does not apply to gifts that are within the annual gift tax exclusion ($13,000 or less). Each person has an exemption from the generation skipping transfer tax. The exemption allows each individual to transfer an amount equal to the estate tax exemption without a generation skipping transfer tax. The generation skipping transfer tax is imposed at the highest gift tax rate (currently 45%) on transfers that "skip" a generation. This tax is in addition to any gift tax on the transfer.

Direct skips in excess of the annul exclusion are subject to tax. Direct skips subject to tax automatically receive an allocation of the donor's available GST exemption amount. If the donor does not want to have any GST exemption allocated to the transfer, the donor must make an affirmative election out of the automatic allocation. This is often referred to as a §2632(b) election. The election must be made on a timely filed (with extensions) gift tax return since the automatic allocation becomes irrevocable after the due date of the return.

To elect out of the automatic allocation, the box in column "**C** 2632(b) election out" "should be checked, a statement clearly describing the transaction and the extent to which the automatic allocation will not apply should be attached to the gift tax return, and a check in payment of the generation skipping transfer tax should be included with the filing of the return.

I. Schedule A, Part 3, Indirect Skips

1. Indirect skip.

An indirect skip is defined in Internal Revenue Code §2632(c)(3)(A) as any transfer of property that is subject to gift tax that is not a direct skip and is made to a GST Trust.

2. GST trust.

A GST trust is defined in Internal Revenue Code §2632(c)(3)(B) as any trust that could have a generation-skipping transfer unless:

(i) The trust provides that more than 25% of principal must be distributed to or may be withdrawn by one or more non-skip persons (a) on or before the individual's 46th birthday; (b) on or before one or more dates specified by the trust instrument that will occur before the individual's 46th

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birthday; or (c) on the occurrence of an event that may be reasonably be expected to occur before the individual's 46th birthday; OR

(ii) The trust provides that more than 25% of the trust principal must be distributed to, or may be withdrawn by, one or more non-skip persons and who are living on the date of death of another person who is more than 10 years older than such individuals; OR

(iii) The trust provides that if one or more individuals who are non-skip persons die before the dates described above, then more than 25% of the trust principal will be distributed to such individual's estate or be subject to a general power of appointment exercisable by such person; OR

(iv) Any portion of the trust would be includible in the estate of a non-skip person (other than the transferor) if the non-skip person died immediately after the transfer; OR

(v) A charitable lead annuity trust, a charitable lead unitrust, a charitable remainder annuity trust or a charitable remainder unitrust.

Crummey withdrawal rights are disregarded in applying the above rules. A crummey power does *not* qualify to take a trust out of the "GST trust" definition. Also, in determining whether a trust is a GST trust you must assume that any powers of appointment held by a non-skip person will not be exercised. Internal Revenue Code §2632(c)(3)(B)(vi).

Irrevocable life insurance trusts are usually GST trusts.

3. The ETIP rule.

If there would be a deemed allocation of GST exemption for an indirect skip of property that would be includible in the person's gross estate for Federal estate tax purposes (the so-called "estate tax inclusion period" or "ETIP"), the deemed allocation is treated as having occurred at the end of the ETIP rather than when the property is actually transferred to the trust. Internal Revenue Code §2632(c)(4).

The gift tax return is used to report a direct or indirect skip that occurs at the end of the ETIP if the ETIP closes during the donor's lifetime and an allocation of GST exemption was not made prior to the termination of the ETIP. If the ETIP closes at the donor's death, it is reported on Form 706. The transfer subject to gift tax is reported for the year in which the transfer is made, while the generation-skipping transfer is reported in the year in which the ETIP closes.

4. GST Exemption Allocation.

As with direct skips, indirect automatically receive an allocation of the donor's available GST exemption amount (after it is first applied to direct skips in that year). If the donor does not want to have any GST exemption allocated to the transfer, the donor must make an affirmative election out of the automatic allocation. This is often referred to as a Internal Revenue Code §2632(c) election. The election must be made:

(1) On a timely filed gift tax return for the calendar year in which the transfer was made;

(2) On a timely filed gift tax return for calendar year in which there would be an automatic allocation for the close of an ETIP; or

(3) On any other dates prescribed by the IRS.

To elect out of the automatic allocation, the box in column "**C** 2632(c) election" should be checked, and a statement clearly describing the transaction and the extent to which the automatic allocation will not apply should be attached to the gift tax return.

In addition, the donor can elect out of the deemed allocation rules as to specific transfers or all transfers made by the donor to a particular trust. The donor may elect out of: (1) a current transfer to a particular trust; (2)a current-year transfer and all future transfers to a particular trust; (3) only certain designated future transfers to a particular trust; (4) all future transfers made by the transferor to any trust (regardless of whether the trust exists at the time of the election out); or (5)any combination of the above. The elections are made by attaching a statement to the gift tax return. Examples of elections are set forth in Treasury Regulation §26.2632-1(b)(4)(iv):

> On March 1, 2006, T transfers $100,000 to Trust B, a GST trust described in section 2632(c)(3)(B). Subsequently, on September 15, 2006, T transfers an additional $75,000 to Trust B. No other transfers are made to Trust B in 2006. T attaches an election out statement to a timely filed Form 709 for calendar year 2006. Except with regard to paragraph (v) of this Example 1, the election out statement identifies Trust B as required under paragraph (b)(2)(iii)(B) of this section, and contains the following alternative election statements:
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> (i)"T hereby elects that the automatic allocation rules will not apply to the $100,000 transferred to Trust B on March 1, 2006." The election out of the automatic allocation rules will be effective only for T's March 1, 2006, transfer and will not apply to T's $75,000 transfer made on September 15, 2006.
>
> (ii)"T hereby elects that the automatic allocation rules will not apply to any transfers to Trust B in 2006." The election out of the automatic allocation rules will be effective for T's transfers to Trust B made on March 1, 2006, and September 15, 2006.
>
> (iii)"T hereby elects that the automatic allocation rules will not apply to any transfers to Trust B made by T in 2006 or to any additional transfers T may make to Trust B in subsequent years." The election out of the automatic allocation rules will be effective for T's transfers to Trust B in 2006 and for all future transfers to be made by T to Trust B, unless and until T terminates the election out of the automatic allocation rules.
>
> (iv)"T hereby elects that the automatic allocation rules will not apply to any transfers T has made or will make to Trust B in the years 2006 through 2008." The election out of the automatic allocation rules will be effective for T's transfers to Trust B in 2006 through 2008. T's transfers to Trust B after 2008 will be subject to the automatic allocation rules,

unless T elects out of those rules for one or more years after 2008. T may terminate the election out of the automatic allocation rules for 2007, 2008, or both in accordance with the termination rules of paragraph (b)(2)(iii)(E) of this section. T may terminate the election out for one or more of the transfers made in 2006 only on a later but still timely filed Form 709 for calendar year 2006.

(v)"T hereby elects that the automatic allocation rules will not apply to any current or future transfer that T may make to any trust." The election out of the automatic allocation rules will be effective for all of T's transfers (current-year and future) to Trust B and to any and all other trusts (whether such trusts exist in 2006 or are created in a later year), unless and until T terminates the election out of the automatic allocation rules. T may terminate the election out with regard to one or more (or all) of the transfers covered by the election out in accordance with the termination rules of paragraph (b)(2)(iii)(E) of this section.

If an allocation of the GST exemption is made to a GST trust it must: (1)clearly identify the trust to which the allocation is being made; (2) state the amount of GST exemption being allocated; (3) if the allocation is late or the inclusion ratio is greater than zero, state the value of the trust assets on the effective date of the allocation; and (4) state the inclusion ratio of the trust after the allocation. A formula allocation such as: "I allocate the minimum amount of my GST exemption necessary to result in an inclusion ratio of zero" should be used if there are any valuation issues.

5. Non GST trusts.

A donor can also elect, under Internal Revenue Code §2632(c)(5)(A)(ii), on a timely filed gift tax return, to have a deemed allocation of the donor's GST exemption apply to any or all transfers made by an individual to a trust that is not a GST Trust by having such trust be deemed as a GST Trust. Although there are no specific instructions, since the donor is electing to treat the non GST trust as a GST trust, it appears that the transfers to the trust should be listed in Part 3 and a statement disclosing the election should be attached. This might be appropriate where a trust does not meet the definition of a GST trust but a GST transfer will or is likely to occur, such as a charitable lead trust where the remaindermen are grandchildren.

6. Relief from Mistakes and Errors.

The IRS power to extend the time to allocate GST exemption, elect out of automatic allocations, and to grant exceptions to time requirements. Internal Revenue Code §2642(g)(1). If the relief is granted, then the value of the transfer for purposes of GST exemption allocation and computing the inclusion ratio is determined on the date of the transfer to the trust.

If that relief is not granted, Internal Revenue Code §2642(b)(3) permits late allocations of the donor's GST exemption based on valuation at the time the allocation is made.

Planning point: Since a late allocation is based on the value at the time of the allocation, other than the time of the gift, if the donor knows that there will be a drop in value, the donor may want to purposefully make a late allocation. Example: an irrevocable life insurance trust holding only term insurance will be worth the least immediately before the annual renewal and premium payment date.

In making determinations as to whether or not to grant an extension or make an exception to the deadlines the IRS is to take into account all relevant circumstances, including evidence of intent in the transfer instrument, and to treat the time for making the allocation or election as if not expressly prescribed by statute. Internal Revenue Code §2642(g)(1)(B).

The IRS is also required to overlook mistakes made in the mechanics of allocating GST exemption. A GST exemption allocation that demonstrates an intention to have lowest proper inclusion ratio is deemed to be, under the substantial compliance rules, an allocation of so much of unused GST exemption as to produce lowest possible inclusion ratio. Internal Revenue Code §2642(g)(2). The IRS is required to take into account all relevant circumstances, including evidence of intention contained in trust instrument or transfer document. A poorly drafted allocation cannot be used against the transferor if the evidence suggests that he or she intended to create the lowest possible inclusion ratio (and therefore the lowest ultimate tax). The IRS must, by statute, read the allocation and the surrounding facts in the manner that would produce the lowest inclusion ratio.

7. Retroactive allocation of GST exemption.

The Internal Revenue Code gives donor's the opportunity to rectify the lack of GST exemption allocation where an unexpected death of a non-skip person (i.e., the death of a child) occurred. The person who died who had an interest or future interest in the trust must have been a lineal descendant of the donor's grandparent, spouse or former spouse, and must be assigned to a generation below the donor's assigned generation. If a retroactive allocation is made, the GST exemption is deemed allocated to previous transfers to the trust on chronological basis. If the retroactive allocation is made by a gift tax return filed on or before the date for filing a gift tax return for the calendar year in which the non-skip person died, the value of the transfer for the purpose of the GST exemption allocation is as of the date of the original transfer. Internal Revenue Code §2632(d)(2).

J. QTIP Gift Tax Election

The QTIP gift tax election is made by listing the QTIP trust (or other property) on Schedule A and entering the value of the property as a deduction on Schedule A, Part 4, line 4. A fractional election may be made by listing the value of the entire property on Schedule A and listing only the elected portion on Part 4, line 8. Failure to make this election for terminable interest property transferred to a spouse on a timely-filed gift tax return will result in a taxable gift in the year of the transfer.

Joint and survivor annuities described in § 2523(f)(6) automatically qualify for QTIP treatment

unless the donor affirmatively elects out of QTIP treatment on the gift tax return. To elect out of QTIP treatment, check the box at line 13 of Schedule A and enter the applicable item numbers from Schedule A. Any annuities that are not listed on line 13 must be entered on Schedule A, Part 4, line 4. The election out of QTIP treatment, once made, is irrevocable.

K. Special Valuation Rules

Transfers of non publicly traded corporate and partnership interests among family members where the donor has retained the right to receive a qualified payment are valued for gift tax purposes under Internal Revenue Code §2701. There are 3 available elections with respect to the treatment of the qualified payment:

1. To treat a qualified payment as other than a qualified payment. Internal Revenue Code §2701(c)(3)(C)(i).
2. to treat a distribution right as a qualified payment. Internal Revenue Code §2701(c)(3)(C)(ii) right.
3. to treat a qualified payment paid more than four years after its due date as a taxable event. Internal Revenue Code §2701(d)(3)(A)(iii)

The elections for the first two are made on a **timely filed** gift tax return reporting the transaction by attaching a statement as specified in Treasury Regulation §25.2701-2(c)(5):

(1) setting forth the name, address and taxpayer identification number of the transferor and the electing individual;

(2) if the transferor and the electing individual are not the same person, the relationship between the transferor and the electing individual;

(3) the nature of the transfer subject to the election;

(4) the distribution right to which the election applies;

(5) the provision of the regulations under which the election is being made; and

(6) if the election is being made to treat a distribution right as a qualified payment:

(i) the amounts assumed to be paid and the time at which they will be assumed to be made, and

(ii) a signed statement by the electing individual that he will be personally liable for any tax resulting from the failure to make the payments assumed in the election.

The third election may be made by attaching a statement to either a timely or late gift tax return for the year in which the payment is received. If the return is timely filed, the taxable event is deemed to occur on the date the qualified payment is made. If the election is made on a late return, the taxable event is deemed to occur on the first day of the month immediately preceding the month in which the return is filed. The statement attached to the return must as specified in Treasury Regulation §25.2701-4(d)(3)(iii):

> (1) Provide the name, address, and taxpayer identification number of the electing individual and the interest holder, if different;
> (2) Indicate that a taxable event election is being made under paragraph (d) of this section;
> (3) Disclose the nature of the qualified payment right to which the election applies, including the due dates of the payments, the dates the payments were made, and the amounts of the payments;
> (4) State the name of the transferor, the date of the transfer to which section 2701 applied, and the discount rate used in valuing the qualified payment right; and
> (5) State the resulting amount of increase in taxable gifts.

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