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The IRS's inroads into the statute of limitations surrounding revaluation of gift tax and the unified credit with regard to estate taxes has caused concern and hesitation on the part of tax and estate planners and their clients. The inability to rely on the statute of limitations provided by the Code can make effective planning difficult, if not impossible. Congress has attempted to address this concern with new rules issued under the Taxpayer Relief Act of 1997.

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Taxpayers who make gifts within the realm of the annual exclusion are not required to file a federal gift tax return.[1] The annual exclusion encompasses gifts of present interests not exceeding $10,000 per beneficiary in any particular calendar year.[2] In the alternative, taxpayers making gifts during the year falling outside the realm of the annual exclusion, or using gift splitting between husband and wife, are required to file such a return even if no gift tax is due.[3]

In the event a taxpayer decides to report a gift by filing a gift tax return, whether required by law or not, the statute of limitations for the return commences and runs for three years.[4] The limitations period can run for six years in the event unreported gifts exceed reported gifts by 25 percent or more.[5] Once the statute of limitations has expired, taxpayers have generally felt some comfort in the belief that the Internal Revenue Service (IRS) could no longer challenge the valuation of the reported gift. However, the IRS has been successful in recent years in circumventing the gift tax statute of limitations. Specifically, in *Smith v. Commissioner,* the Tax Court ruled that a gift, for which the statute of limitations had already expired, could be revalued by the IRS in determining the amount of unified credit previously utilized.[6] This redetermination of the value of a gift subsequent to the expiration of the limitations period can cause taxpayers significant concern due to the interplay between the gift tax and subsequent estate tax calculation.

The Statute of Limitations Problem

In *Smith v. Commissioner,* the taxpayer made gifts of certain corporate stock on December 22, 1982.[7]

He then filed a timely gift tax return on March 23, 1983, reporting the gift at a value of $284,871 and paying the resulting gift tax. The taxpayer then died on December 5, 1984. On September 6, 1985, the personal representative of the estate filed a federal estate tax return, in which the gifted stock was reported at $284,871. The time to assess a deficiency for the gift tax expired on April 15, 1986. However, the Commissioner issued a notice of deficiency dated September 2, 1988, reflecting an estate tax deficiency based upon the gifted stock. For estate tax purposes, the Commissioner valued the gift at $668,495.[8] The issue to be determined by the Tax Court in *Smith* was whether the Commissioner was entitled to revisit the valuation of the stock in question for purposes of calculating the estate tax liability for years that are closed to such an increase for gift tax purposes.[9]

The court began its analysis by examining the language of Section 2504(c) of the Internal Revenue Code (Code), which addresses the statute of limitations for gift tax purposes. This section provided as follows:

> Valuation of Certain Gifts for Preceding Calendar Periods. If the time has expired within which a tax may be assessed under this chapter . . . and if a tax under this chapter . . . has been assessed or paid for such preceding calendar period, the value of such gift made in such preceding calendar period shall, for purposes of computing the tax under this chapter for any calendar year, be the value of such gift which was used in computing the tax for the last preceding calendar period for which a tax under this chapter . . . was assessed or paid.[10]

The taxpayer read this section of the Code and took the position that the Commissioner should not be able to revisit the gift tax valuation for purposes of determining the estate tax. To do so, argued the taxpayer, would "thwart the statute of limitations for assessment of gift taxes and the legislative intent in unifying the estate and gift taxes."[11]

The Commissioner agreed that the Code section cited prevented the IRS from revaluing a gift where, as in this case, the taxpayer has paid the tax and the limitations period had expired. However, the Commissioner also argued that the cited language only prohibits revaluation of such gifts for purposes of the gift tax.[12] In other words, the language does not prohibit such revaluation for purposes of determining the appropriate amount of estate tax due.

The Tax Court ultimately ruled in favor of the Commissioner in the *Smith* case, indicating the IRS could revalue the gift in question for estate tax purposes, but not for gift tax purposes.[13] This decision raises at least two significant concerns for tax advisors who are counseling their clients on estate and gift tax issues. Consider the following examples:

Example 1: Assume a taxpayer makes a gift of corporate stock in a particular year that the taxpayer values at $510,000. In order for the taxpayer to avoid paying any gift tax on the transfer, he uses the $10,000 annual exclusion and $500,000 of his unified credit asset equivalent amount. This results in $175,000 of the unified credit asset equivalent remaining for use at the date of death (i.e., $675,000 – $500,000). A gift tax return is timely filed, the statute of limitations for the return expires, and the taxpayer subsequently dies. Prior to the taxpayer's death, he had discarded any records regarding the transaction because the limitations period had expired. At the date of death, the IRS argues that the gift of stock should have been valued at $610,000, not $510,000. If the IRS is correct in its analysis, the amount of unified credit asset equivalent remaining for use at the date of death would be less than anticipated. The asset equivalent is now $75,000 (i.e., $675,000 – $600,000), rather than the anticipated $175,000. The taxpayer's estate will now bear a greater estate tax liability as a result of the revaluation that has taken place for the earlier gift (assuming the estate exceeds the unused asset equivalent). The above scenario indicates that taxpayers would be required to retain records of gifting transactions until the date of death in the event the IRS decided it would revisit this valuation issue. In addition, a taxpayer would never actually know how much, if any of the asset equivalent remains until the estate received the final Estate Tax Closing Letter from the IRS.

Example 2: An additional problem could surface for taxpayers. Assume the same set of facts as set forth in the preceding example. However, assume that the IRS audits the timely filed gift tax return during the taxpayer's lifetime. Based upon the revaluation, the taxpayer still does not owe any gift tax as a result of increased utilization of the unified credit. However, under prior law, the taxpayer had no recourse in the Tax Court for a declaratory judgment since there was no tax due.[14] This effectively placed taxpayers in a situation where they did not know whether additional gifts should be made, and if so, in what amounts. The taxpayer in this example only has $75,000 of asset equivalent remaining. Concerned about another IRS revaluation, the taxpayer may not exercise his right to utilize the additional $75,000 amount due to the potential gift tax liability.

The result of the previous IRS revaluation practice essentially forced taxpayers to retain records of lifetime gifts until after the date of death and until such time as the estate received the Estate Tax Closing Letter from the IRS. In addition, this revaluation practice kept taxpayers guessing how much of the unified credit would actually be available at the date of death because of gifts made during their lifetime. There could be little certainty on the part of taxpayers when significant lifetime gifts were made.

Taxpayer Relief Act of 1997

Congress provided taxpayers with a potential solution to help alleviate the problems outlined above. Section 506(a) of the Taxpayer Relief Act of 1997 (TRA '97) states that for gifts made after August 5, 1997 (the date of enactment), the IRS may not challenge taxpayer valuations once the statute of limitations period has expired.[15] In order for taxpayers to utilize the statute of limitations as a defense, the following two conditions must be met:

1. The gift must be disclosed on a gift tax return in a manner adequate to apprise the IRS of the nature of the gift; and
2. The statute of limitations must in fact have expired for purposes of assessing additional gift tax.[16]

In the event a taxpayer meets these two conditions, he can rely on the statute of limitations to provide a degree of certainty that the valuation issue is closed.[17] The reverse is also true. That is, if a gift tax return is not filed, or if a return is filed but adequate disclosure is not made, TRA '97 provides that the gift tax assessment may be made at any time.[18] TRA '97 appears to relieve taxpayers of some of the recordkeeping requirements and the uncertainty brought about by cases such as *Smith*. However, many tax advisors have continued to recommend retaining all records of gift transactions even after Section 506 of TRA '97 was enacted.

The concern with Section 506 of TRA '97 was the precise definition of "adequate disclosure." In the event a gift is not "adequately disclosed" to the IRS on a gift tax return, the limitations period does not begin to run, even if a gift tax return has been timely filed.[19] Prior to final regulations being issued, taxpayers and the IRS may have disagreed whether the disclosure made on the gift tax return was adequate to satisfy the provisions of TRA '97 Section 506(a). Thus, taxpayers were still left with the same concerns regarding valuation issues. Although TRA '97 did not resolve all uncertainty regarding gift valuation issues, it did add one additional provision to the Code, which will benefit taxpayers. Prior to the Act, the IRS could audit a gift tax return on a timely basis and increase the value of a particular gift. In the event no tax was due as a result of either the annual exclusion or unified credit, the Tax Court would have no jurisdiction over this determination since there was no tax due.[20] (See example 2, above.) Section 506(c) of TRA '97 creates a declaratory judgment procedure in the Tax Court for determining the value of a gift. Specifically, in the case of an actual controversy involving a determination by the Secretary of the value of any gift shown on the gift tax return or disclosed on a return or an attached statement, upon the filing of an appropriate pleading, the Tax Court may make a declaration of the value of such gift.[21] Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such. The Tax Court cannot issue such a declaratory judgment until the taxpayer has exhausted all available administrative remedies within the IRS.[22]

Final Regulations

The IRS has now issued final regulations regarding the valuation of gifts for purposes of making "adequate disclosure" and commencing the limitations period.[23] The final regulations, adopting a modified version of the proposed regulations, are applicable for gifts made after December 31, 1996, for which the gift tax return for such calendar year is filed after December 3, 1999.[24]

Recall that Code Section 6501(c)(9) indicates the limitations period only begins to run if the gift is adequately disclosed on the gift tax return.[25] A gift will be considered "adequately disclosed" on the return only if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the basis of the reported value.[26] More specifically, the final regulations call for the following to be disclosed:

- A description of the transferred property and any consideration received by the transferor.
- The identity of, and relationship between, the transferor and each transferee.
- If the property is transferred in trust, the trust's tax identification number and a brief description of the trust terms, or in lieu of a brief description of the trust's terms, a copy of the trust instrument.
- Except as provided in Treasury Regulations Section 301.6501-1(f)(3), a detailed description of the method used to determine the fair market value of the property transferred, including any financial data (i.e., 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. The requirements of this paragraph can also be met if the taxpayer submits an appraisal of the transferred property that meets the specific requirements of Section 301.6501(c)-1(f)(3).
- 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)).[27]

Planning Opportunity

Prior to TRA '97, many taxpayers did not even consider filing a gift tax return if the value of the gift came within the realm of the annual exclusion amount because law did not require such a return. Those taxpayers that did file such returns often did not disclose many of the details of the gift transaction or how valuations were computed for non-cash gifts. As a result of the new law and related final regulations, taxpayers now have an incentive to file such returns and make the full disclosure called for in the regulations.

TRA '97 provides that, for purposes of determining the federal estate tax, the amount of prior taxable gifts is the value as "finally determined."[28] The final determination of the value of a gift can be made in one of four ways:

1. The value is shown on a gift tax return and such value is not contested by the Secretary before the expiration of the statute of limitations with respect to such return.[29] For purposes of this provision, the value of an item shall be treated as shown on a return if the item is disclosed in the return, or an attached statement, in a manner adequate to apprise the Secretary of the nature of such item.
2. The value is specified by the Secretary and such value is not timely contested by the taxpayer.[30]
3. The value is determined by a court.[31]
4. The value is determined pursuant to a settlement agreement with the Secretary.[32]

Clearly, taxpayers should attempt to have the valuation of gifts settled in accordance with provision number 1. It provides the greatest certainty at the earliest point in time. Transfer tax issues can no longer be ignored or disguised even when the transfer does not exceed the annual exclusion limit. Full disclosure in accordance with the final regulations is the position all tax advisors should be promoting with taxpayers at this point in time. Even for gifts of non-cash assets not exceeding the annual exclusion, taxpayers should be giving serious thought to filing a gift tax return for the sole purpose of commencing the limitations period. Advisors who do not recommend full disclosure to their clients in the fashion contemplated by the new regulations may cause their clients to incur larger transfer taxes. Unfortunately, the unnecessary transfer taxes may not be realized until years after the initial gift.

Endnotes

1. *See* I.R.C. § 2503(b)(1).
2. *See id.* (In the case of gifts made in a calendar year after 1998, the $10,000 amount shall be increased by an amount equal to $10,000, multiplied by the cost-of-living adjustment determined under Section 1(f)(3) for such calendar year by substituting "calendar year 1997" for "calendar year 1992" in subparagraph (B) thereof. If any amount as adjusted under the preceding sentence is not a multiple

of $1,000, such amount shall be rounded to the next lowest multiple of $1,000.)

3. *See* I.R.C. § 2513(a),(b); Treas. Reg. §§ 25.2513-(1),(2).

4. *See* I.R.C. § 6501(a).

5. *See* I.R.C. § 6501(e)(2).

6. Estate of Smith v. Commissioner, 94 T.C. 872 (1990).

7. *Id.* at 873.

8. *Id.*

9. *Id.*

10. *See* I.R.C. § 2504(c) (1984).

11. Smith at 874.

12. *See id.*

13. *Id.* at 878.

14. *See* Tax Court Rule 210(c), amended by TRA '97 Section 506(a).

15. Taxpayer Relief Act of 1997, P.L. No. 105-34 (1997). Section 506 of the Act provides as follows:

    SEC. 506. GIFTS MAY NOT BE REVALUED FOR ESTATE TAX PURPOSES AFTER EXPIRATION OF STATUTE OF LIMITATIONS.

    (a) In General.—Section 2001 (relating to imposition and rate of estate tax) is amended by adding at the end the following new subsection:

    (f) Valuation of Gifts.—If—

    (1) the time has expired within which a tax may be assessed under chapter 12 (or under corresponding provisions of prior laws) on the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)), and

    (2) the value of such gift is shown on the return for such preceding calendar period or 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 gift, the value of such gift shall, for purposes of computing the tax under this chapter, be the value of such gift as finally determined for purposes of chapter 12.

    (b) MODIFICATION OF APPLICATION OF STATUTE OF LIMITATIONS—Paragraph (9) of section 6501(c) is amended to read as follows:

    (9) GIFT TAX ON CERTAIN GIFTS NOT SHOWN ON RETURN—If any gift of property the value of which (or any increase in taxable gifts required under section 2701(d) which) is required to be shown on a return of tax imposed by chapter 12 (without regard to section 2503(b)), and is not shown on such return, any tax imposed by chapter 12 on such gift may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time. The preceding sentence shall not 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. The value of any item which is so disclosed may not be redetermined by the Secretary after the expiration of the period under subsection (a).

    (c) DECLARATORY JUDGMENT PROCEDURE FOR DETERMINING VALUE OF GIFT—

    (1) IN GENERAL—Part IV of subchapter C of chapter 76 is amended by inserting after section 7476 the following new section:

    SEC. 7477. DECLARATORY JUDGMENTS RELATING TO VALUE OF CERTAIN GIFTS.

    (a) CREATION OF REMEDY—In a case of an actual controversy involving a determination by the Secretary of the value of any gift shown on the return of tax imposed by chapter 12 or disclosed on such return or in any statement attached to such return, upon the filing of an appropriate pleading, the Tax Court may make a declaration of the value of such gift. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

    (b) LIMITATIONS—

    (1) PETITIONER—A pleading may be filed under this section only by the donor.

    (2) EXHAUSTION OF ADMINISTRATIVE REMEDIES—The court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service.

    (3) TIME FOR BRINGING ACTION—If the Secretary sends by certified or registered mail notice of his determination as described in subsection (a) to the petitioner, no proceeding may be initiated under this section unless the plead-

ing is filed before the 91st day after the date of such mailing.

(2) CLERICAL AMENDMENT—The table of sections for such part IV is amended by inserting after the item relating to section 7476 the following new item:

SEC. 7477. DECLARATORY JUDGMENTS RELATING TO VALUE OF CERTAIN GIFTS.

(d) CONFORMING AMENDMENT—Subsection (c) of section 2504 is amended by striking "and if a tax under this chapter or under corresponding provisions of prior laws has been assessed or paid for such preceding calendar period".

(e) EFFECTIVE DATES—

(1) IN GENERAL—The amendments made by subsections (a) and (c) shall apply to gifts made after the date of the enactment of this Act.

(2) SUBSECTION (b)—The amendment made by subsection (b) shall apply to gifts made in calendar years ending after the date of the enactment of this Act.

16. *See id.*

17. *See id.*

18. *See* TRA '97 § 506(b); see also Treas. Reg. § 301.6501(c)-1(f).

19. *See id.*

20. *See* Tax Court Rule 210(c), amended by TRA '97 Section 506(a).

21. *See* TRA '97 § 506(c).

22. *See id.*

23. 64 Fed. Reg. 67,767 (1999).

24. *See* TRA '97 § 506(a).

25. *See id.*

26. *See id.*

27. *See* Treas. Reg. § 310.6501(c)-1(f).

28. *See* TRA '97 § 506(a).

29. *See* I.R.C. § 2001(f)(2)(A).

30. *See* I.R.C. § 2001(f)(2)(B).

31. *See* I.R.C. § 2001(f)(2)(C).

32. *See id.*