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Steve Leimberg's Estate Planning
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Subject: Joy Matak, Steven B. Gorin & Martin M. Shenkman - 2020 Planning Means a Busy 2021 Gift Tax Return Season

“Gift tax returns are often incredibly complicated with layers of issues, technical decisions, and disclosure requirements. 2020 created additional and sometimes novel gift tax reporting considerations. This discussion underscores the imperative for collaboration among the estate planning practitioner and the tax preparer. Disclosures should be carefully constructed in order to bolster the client’s position against a challenge by the IRS as to the operation of the valuation adjustment clause.

The gift tax return preparer should seek counsel’s review and comment prior to finalizing the gift tax return for filing with the IRS. This will likely increase the costs of preparing and filing the gift tax return, but it will be well worth it.

Gift tax return preparation practice should be viewed by practitioners as the danger that it is. If a client will not permit you to handle a Form 709 filing in the manner you as a professional believe necessary, pass on accepting the work. Familiarize yourself with gift tax guidelines and rules carefully to ensure nothing is overlooked.”

Joy Matak, **Steven B. Gorin** and **Martin M. Shenkman** provide members with timely commentary that should be of help to practitioners who are tasked with reporting 2020 gift tax transactions. Members who wish to learn more about this topic should consider watching their exclusive **LISI** Webinar titled: “2020 Gift Tax Returns: Practical Tips How to Report Common 2020 Transactions**”** that will be held this Friday, February 5th from 3:00PM ET - 4:30PM ET. For more information click this link: Joy/Steve/Marty

Joy Matak, JD, LLM is a Partner at **Sax and Head** of the firm’s **Trust and Estate Practice**. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending

and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law.

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He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network and Weill Cornell Medicine Professional Advisory Council.

Here is their commentary:

EXECUTIVE SUMMARY:

Gift tax returns are often incredibly complicated with layers of issues, technical decisions, and disclosure requirements. 2020 created additional and sometimes novel gift tax reporting considerations.

This discussion underscores the imperative for collaboration among the estate planning practitioner and the tax preparer. Disclosures should be carefully constructed in order to bolster the client's position against a challenge by the IRS as to the operation of the valuation adjustment clause. The gift tax return preparer should seek counsel's review and comment prior to finalizing the gift tax return for filing with the IRS. This will likely increase the costs of preparing and filing the gift tax return, but it will be well worth it.

Gift tax return preparation practice should be viewed by practitioners as the danger that it is. If a client will not permit you to handle a Form 709 filing in the manner you as a professional believe necessary, pass on accepting the work. Familiarize yourself with gift tax guidelines and rules carefully to ensure nothing is overlooked.

COMMENT:

Throughout 2020, estate planning practitioners encouraged their clients to pursue estate and asset protection planning aggressively as the tax world anticipated the impact of harsh transfer tax changes to be enacted by Democrats if they gained control in the November national elections. This was all amidst a once-in-a-lifetime pandemic that affected every aspect of daily life.

As COVID cases rose throughout the country, tax experts and pundits noted that the volatile economy and rising deficit could force federal and state governments to consider additional tax legislation as early as the

beginning of 2021. Practitioners were cautioned to forewarn clients how economic and political uncertainties might create more chaos for them, their finances and their estate plans.

Tax advisers cautioned clients to act before the end of 2020 before the effective date of any changes should there be a Democrat victory. In particular, advisers voiced the concern that tax legislation enacted in 2021 after the election could be made retroactive to January 1, 2021. Practitioners also pointed to the perfect storm that made 2020 the year to plan: exceptionally high lifetime exemption from gift and estate taxes ($11.58 million per taxpayer), historically low interest rates, and artificially depressed asset values. On this advice, many practitioners advised their client to accomplish significant wealth transfers throughout 2020. Anecdotally, it appeared that the latter portion of 2020 may have been the most intense period in estate planning history in terms of the volume of planning and inter-vivos transfers. This tidal wave of estate planning will all need to be disclosed on timely filed gift tax returns in 2021. The objective of this article is to provide practitioners with practical guidance on preparing 2020 gift tax returns. In particular, attention will be given to some of the specific transaction types the authors believe received particular attention in 2020 and how to disclose them.

Gift Tax Returns General 2020 Cautions

Gift tax returns appear to be seductively simple. It's not a long return, the tax return template does not seem particularly complex to complete, so how hard can it be? Preparing a gift tax return correctly is not an easy task, and professionals who don’t prepare them regularly and with care can easily make a myriad of mistakes. There are so many areas of uncertainty, layers, and nuances that it's virtually impossible for anyone preparing a gift tax return who does not have considerable experience to miss important issues. Reporting 2020 transfers, especially those involving transfers in trust, should not be treated lightly. This is a particular concern for 2020 since so many taxpayers who made transfers may rely on their general practice attorney or CPA who may not specialize in trust and estate matters, to prepare their gift tax return. This newsletter, however, will not focus on gift tax return basics, but rather on reporting common 2020 transactions.

It will be unusual for 2020 transfers for clients to have made gifts that intentionally generate gift tax. The 2020 environment, perhaps with the exception of elderly or ill clients, was not one in which taxable gifts would prove generally advantageous. Also, few taxpayers are willing to intentionally incur a gift tax. In some instances, 2020 planning may have intentionally incurred gift tax. For example, a terminally ill client in 2020 may have believed that paying a gift tax at the 2020 rate of 40% and having that gift tax paid excluded from their estate if they survive three years, and in anticipation of a possible significant increase in the rates in the future, may have been thought to be advantageous. Those returns, however, will likely be few in number.

When no gift tax is due, tax returns may seem somehow less urgent. Nothing could be farther from the truth. Failure to file a gift tax return and disclose transactions "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" can delay the tolling of the statute of limitations,[i] and regulations impose specific requirements for "adequate disclosure." In other words, gifts not adequately disclosed may be subject to challenge indefinitely. Additionally, a proper gift tax return filing may include elections that protect the client's future planning objectives such as Generation Skipping Transfer tax exemption allocations, gift splitting, etc. For the most part, elections must be made correctly and timely or else the opportunity is lost.

Nuances of 2020 Gift Tax Compliance

In many ways, planning in 2020 looked different from that which was done in prior years. Many clients were reluctant to engage in significant wealth transfers without safety valves and flexibility that would protect their interests in the event that the stock market plunged. Some clients had already used their high exemptions and needed to consider other wealth transfer strategies to reduce their families' overall tax exposure. In some cases, plans had to be pieced together quickly in the last weeks between the November election and New Year's Eve, most often without a final valuation of the assets being transferred.

The unique challenges of 2020, especially the time compression of later 2020 planning, forced practitioners to become creative in crafting plans to address their clients' concerns. The challenge for 2021 is to ensure that the specifics of each transaction are disclosed adequately on timely filed

gift tax returns so that the statute of limitations might run. Often this work will be done by CPAs who may not have been part of the original planning discussions. That could be particularly problematic if the CPA was excluded from planning and the attorney handling it believes that a gift tax return is not necessary, when in fact it might be, or perhaps when the CPA views the filing of a return to report a non-gift transaction differently than the attorney may. Consider the language in the instructions to Form 709: "The gift tax applies not only to the free transfer of any kind of property, but also to sales or exchanges, not made in the ordinary course of business, where value of the money (or property) received is less than the value of what is sold or exchanged." While different views are not unusual, it is important that the client be informed of all perspectives. Assume one adviser recommends against reporting a non-gift transaction, such as a note sale transaction, and another adviser recommends filing to toll the statute of limitations. The client should be informed of the pros and cons of each position and make the ultimate decision.

Following are explanations of 2020 planning techniques with suggestions and recommendations for how a gift tax return preparer might disclose those transactions in order to satisfy adequate disclosure regulations.[ii]

2020 Valuations

2020 was marked with substantial market volatility and economic uncertainty.

At the time of this writing, some stock market indices have reached all-time highs. Other stock prices remain low and have not fully recovered from the impact of COVID-19. The impact of COVID-19 on valuations is incredibly unequal. Businesses that have benefited from sheltering in place, increased concerns over disinfecting, etc. have burgeoned in value. Other businesses have dropped in value, and many have simply closed their doors. For many businesses, real estate investments and other assets, uncertainty as to their economic future was significant when 2020 transfers were made.

This uncertainty presented the opportunity for clients to transfer temporarily depressed assets out of their estates using less gift tax exemption (or forgive part or all of note balances if a note sale transfer had been used in prior years, etc.) than what the asset would have been estimated to be

worth once the Covid-induced uncertainties have resolved. By transferring noncontrolling, unmarketable interests in businesses, clients may have made transfers at values much less than if all of the business were sold to one buyer. Each of these points raises specific issues to gift tax return disclosures.

Specific recommendations for gift tax return preparer:

- Asset values must be disclosed in a way that satisfies the adequate disclosure regulations.[iii]
- If a valuation is provided to support the value of the assets, the preparer should review the valuation to confirm that it meets Rev. Rul. 59-60.
- The preparer should be sure to check the box at the top of page 2 of the Form 709, answering YES to the question: "*Does the value of any item listed on Schedule A reflect any valuation discount?*" when that is applicable. A question of note as to 2020 transfers is whether "valuation discount" encompasses a valuation impact of Covid. The instructions to Form 709 provide: "If the value of any gift you report in either Part 1, Part 2, or Part 3 of Schedule A includes a discount for lack of marketability, a minority interest, a fractional interest in real estate, blockage, market absorption, **or for any other reason**, answer "Yes" to the question at the top of Schedule A. Also attach an explanation giving the basis for the claimed discounts and showing the amount of the discounts taken [highlight added]." Some may suggest that a reduction in value to reflect the uncertainty of Covid on the business might require checking the box, not merely the lack of control and other more traditional discounts, but others may suggest that uncertainty included in management estimates of future earnings is not really a "discount." The box for discounts has always been a dicey topic for operating businesses, the value of which tends to be based on a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA). The EBITDA multiplier (a form of a price-to-earnings ratio) tends to be derived from results of publicly-traded companies, which have discounts for lack of control baked into them instead of being separately stated.

- The preparer should also attach an explanation giving the basis upon which discounts were taken in the description of the gift and also

showing the amount of the discounts taken. The following language might be helpful:

> The Fair Market Value of [the asset conveyed] was determined in good faith based on the valuation report proffered by [valuation professional], a third party valuation professional, in accordance with Revenue Ruling 59-60 and other regulations and rulings where appropriate (the "valuation report") as of [the date of the gift]. The valuation report uses the [valuation methodology], applying discounts of XX% for Lack of Control and YY% for Lack of Marketability, for a combined blended discount rate of XY%. In addition, the appraisal reflects a discount to reflect the uncertainty of Covid-19 in the form of an increase in the discount rate from z% to zz% [modify as appropriate].

Valuation Adjustment Clauses

Some practitioners have increased the use of valuation adjustment clauses to minimize the potential gift tax risk of a large transactions. This was particularly true towards the end of 2020 when so much planning was occurring that valuation professionals were unable to complete valuation reports in time for the transfers. This was more likely to be the case for transfers completed close to the end of 2020. In those situations, planners may have had to use estimates of value to get the transactions completed before year-end. This raised somewhat unique issues in 2020 valuation adjustment mechanisms.

Another unique aspect of valuation adjustment mechanisms used in 2020 planning was that there was a concern in 2020 amongst many practitioners that major estate tax legislation could be enacted in 2021 that could include the elimination of valuation discounts, tax transfers to grantor trusts in the settlor's estate, etc. Those concerns raised issues with one of the favored valuation adjustment mechanisms, a *Wandry* clause. While the Tax Court in *Wandry* upheld the defined value mechanism based on the specific wording of the clause in the assignment documents, the IRS issued a statement that the commissioner did not acquiesce to the Court's conclusion. Although nonacquiescence signals strong disagreement, the IRS apparently did not have the confidence to appeal the case, presumably

because of a prior taxpayer-favorable related precedent in the court to which the case would been appealed. The *Wandry* approach results in only the intended dollar amount of the assets being transferred with any excess above that amount remaining in the transferor's estate. However, those remaining interests could be subjected to harsh restrictions if the most stringent of the Democrat proposals are enacted. As a result, variations of the *Wandry* mechanism were sometimes used. Practitioners preparing gift tax returns need to be alert to these variants and the impact on Form 709 reporting.

Some transactions may have been structured using some application of one of the notable defined value cases.[iv] These types of mechanisms are based on the entirety of the intended value being transferred away from the transferor. However, if there is an excess value over what the buyer in the transaction is paying as a result of an IRS audit adjustment, that excess value is poured into a non-taxable receptacle. This non-taxable receptacle could be a charity, a grantor retained annuity trust ("GRAT"), marital trust, or an incomplete gift trust.

Words matter in valuation adjustment clauses. In a recent case, *Nelson*, the taxpayer's valuation adjustment mechanism failed because it did not use the requisite language of referring to "gift tax value as finally determined" and instead had a reference to an appraised value.[v] The preparer should, as a professional courtesy, notify the drafting attorney if the language required in the *Nelson* case does not appear to have been used. Then, it may also be advisable to notify the client of the issue. If the language is wrong, counsel might consider whether the provision can be amended, but it is not certain that a correction in problematic language after the fact would be effective. If the phrase "gift tax value as finally determined" had been used in the underlying transfer documents, the gift tax return preparer may wish to quote that language in the disclosure. If not, the practitioner would be well advised to attach the transfer documents without highlighting the potential issue; after all, the client does believe that the appraisal was correct.

A gift tax return preparer is confronted with a valuation adjustment clause must exercise additional caution in disclosing the contours of the transaction.

Specific suggestions for gift tax return preparer:

- Review the valuation adjustment clauses carefully. Consider the *Nelson* issue identified above. But that is not the only consideration. Which receptacle was used in the governing documents for the spillover, if a spillover was used? What might be appropriate to disclose as to that spillover receptacle? If the spillover is to an incomplete gift trust, that trust might be contained in the same trust instrument that is the primary donee or purchaser. However, if the spillover is to a GRAT the gift tax return should disclose all relevant information as to the GRAT and attach the GRAT document. In all situations, consider attaching the instrument incorporating the defined value mechanism. The Form 709 instructions provide: "If the gift was made by means of a trust, attach a certified or verified copy of the trust instrument to the return on which you report your first transfer to the trust. However, to report subsequent transfers to the trust, you may attach a brief description of the terms of the trust or a copy of the trust instrument." It is strongly recommended that preparers of gift tax returns attach a complete copy of the trust document to every gift tax return it relates to, even if the trust document had been attached to a prior return. It is not worth the risk of attaching a description that may prove inaccurate or incomplete, when it is easier and more complete to attach a copy of the actual trust instrument.

- Be certain to identify follow up steps and key dates that might pertain to the valuation adjustment mechanism and be confirm whether the client and which advisers will monitor those items. While this may not be pertinent to the direct filing of the gift tax return, it may be essential to the success of the plan. For example, if there is a spillover to a charity, what should be reported on the donor's income tax return and when should a potential refund claim be filed? If there is a spillover to a GRAT but the required GRAT payments are not made, the GRAT will fail. Some practitioners fund a GRAT used in a spillover with other assets so that the GRAT operates from inception like a GRAT. In such instances it may be prudent to confirm that someone is assuming responsibility for that administration. Someone, perhaps the CPA who is preparing the gift tax return, should calendar the date at which the gift tax statute of limitations tolls as that may be the trigger in the governing transfer documents for the final determination of the allocation of the interest in the asset transferred.

- Defined value mechanisms may leave open the determination of which party will own which interests in the transferred asset. Practitioners should inquire as to who is preparing those income tax returns and whether they have the knowledge of the transaction so that the reporting is consistent with the defined value mechanism. For example, if the client gifted LLC interests subject to a *Wandry* clause to an irrevocable trust, the K-1s issued to each of the trust and the donor should reflect, perhaps on an attached statement, that the percentage interests on Form K-1 are estimates subject to a defined value mechanism. Perhaps the document creating that mechanism should be specifically referenced. In addition, the donor's income tax return should also reflect similar language. Finally, to complete the circle, - trust records should reflect similar language.

- Collaborate closely with the planning practitioner to ensure a complete understanding of how the valuation adjustment will work. The preparer should be certain that all documents pertaining to the transaction have been provided. This is not only necessary to the preparation of the exhibits to the gift tax return to meet adequate disclosure requirements, but also as the preparer may wish to hold certain documents in a permanent file supporting the gift tax return even if those documents are not included with the return.

- Make specific disclosures on the gift tax return showing all of the related transactions in the event that the valuation adjustment is invoked.

Disclosing the Two-Tiered Valuation Adjustment Provision

For many clients, planning in 2020 was a rush to divest themselves of all the equity in closely held businesses, whether to use up some or all of their lifetime exemptions, or to shift value (*e.g.*, by a note sale) out of their estate while valuation discounts and other benefits may be achieved prior to a change in the law. On these occasions, some estate planners took an extra step to avoid a *Wandry* clause resulting in some part of the equity being returned to the transferor.

One such approach is to use what one of the authors has dubbed a "two-tiered *Wandry*" arrangement. This could consist of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets)

left by the *Wandry* adjustment clause if the clause is triggered. In other words, the transferor makes a gift of a specified value of the shares of the entity, believing that all of the transferor's interest in the entity is equal to the value being transferred. In the event that the shares are re-valued on audit (such that the value that the transferor sought to transfer does not cover all of the shares), the transferor will have sold shares that exceed the intended gift value. The second tier of the double *Wandry* arrangement could consist of a second sale of any shares, effective as of the same date as the primary *Wandry* sale, that remain by operation of the *Wandry* arrangement in the selling taxpayer or trust's hands. The price for this second sale, if any, could be for a price equal to the gift tax value as finally determined. The sale would be supported by a note upon which interest accrues from closing and is required to be made current within a specified time period, *e.g.*, 90-days of the final determination. Apropos to 2020 transfers, the concern over dramatic estate tax changes may have well encouraged many practitioners[vi] to utilize the two-tier *Wandry* clause as future transfers might not qualify for discounts, etc. if the law changes. Further, using a two-tier *Wandry* transfer may both protect against an unintended gift tax and simultaneously avoid a *Powell* challenge for estate inclusion. In *Powell*, the taxpayer "in conjunction with others" retained control over the FLP interests transferred resulting in estate inclusion. With a traditional application of a *Wandry* clause interests in an entity could remain in the transferor's control resulting in a *Powell* challenge. Using the two-tier *Wandry* may avoid that problem, and do so at a time in the law before discounts might be restricted or eliminated by a Biden Administration.

For the most part, these types of arrangements would rely on grantor trusts, so that, in the event that the *Wandry* clause is triggered, the transferor could avoid an income tax – and possibly income tax interest and penalties – for a sale transaction deemed to have occurred on the date when the original gift was made.

The following is an example of how a gift tax return preparer might disclose a transaction that includes a valuation adjustment with a sales provision:

Example: On August 1, 2020, Jack transfers shares in his closely held business, Entity, with an aggregate fair market value of $1 million to the Jack Family Trust. Jack believes that he has transferred a 25% interest in the closely held business, but if it turns out that the aggregate value of a

25% interest was worth more than $1 million, Jack will be deemed to have sold the excess shares to the Jill Trust, which is a grantor trust.

In this case, the gift tax return preparer should be to make the following disclosures:

1. The gift of $1 million worth of shares in his closely held business to the Jack Family Trust.

    - Include a copy of the Assignment document, trust agreement, and the qualified valuation report.
    - Report the gift on the appropriate section of Schedule A and show a $1 million gift value. Be sure to include the basis of the interests believed to have been conveyed (in this case, estimated at 25% of the entity).
    - Use careful language to describe the transaction. Following is an example:

      Jack estimated that the value of a 25% undivided membership interest in the Entity was worth $1 million, based upon the taxpayer's good faith reliance on the valuation report. This preliminary allocation of a 25% interest in the Entity to the Jack Trust, based upon the valuation performed by [third party valuation professional], a third party valuation professional, in accordance with Revenue Ruling 59-60 and other regulations and rulings where appropriate, is for administrative convenience only with respect to the value, until the fair market value of the Entity interests is finally determined for federal gift tax purposes.

      The estimate of the percentage of gifted percentage interests in the Entity shall be revised accordingly so that the percentage of Entity interests gifted to the Jack Trust equals the corresponding dollar amount of $1,000,000, to the extent that values are finally determined for gift tax purposes.

2. If an escrow agent was used in the transaction, *e.g.* to hold title documents impartially on behalf of the Jack Trust and the Jill Trust

until either the gift tax statute of limitation passes, or the gift tax valuation is finally determined. If an escrow arrangement is used that should be disclosed as that may be a positive factor to demonstrate that the adjustment will in fact be made should one occur.

3. The sale of an undetermined value of shares in his closely held business to the Jill Trust.

    - Reference the Assignment Document and qualified valuation report.

    - Include a copy of the Jill Trust and sales documents: promissory note, sales agreement, etc.

    - Report the sale on the appropriate section of Schedule A and show a $0 gift value. Since Jack has estimated in good faith that the fair market value of the interests sold is $0, Jack should report the basis of the interests conveyed by sale as $0.

    - Use careful language to describe the sale to the Jill Trust. Following is an example of what was sold:

      That percentage of interests in the Entity deemed to have been sold by operation of that certain [Assignment Instrument] executed on [original date of the transaction], between, and among Jack and the trustees of the Jack Trust and the Jill Trust, as may be adjusted upon a final determination for federal gift tax purposes of the fair market value of the interests in the Entity as of [original date of the transaction].

      The preliminary allocation of 0% interest in the Entity to the Jill Trust based upon the valuation performed by [third party valuation professional], a third party valuation professional, in accordance with Revenue Ruling 59-60 and other regulations and rulings where appropriate, is for administrative convenience only with respect to the value and percentage of the Entity interests until the fair market value of the Entity interests is finally determined for federal gift tax purposes.

Consideration should also be given to how the transfers are reported on the income tax returns for the Entity and the trusts. Perhaps the income tax return preparer should include a footnote on each return to reflect the effect of the valuation adjustment clause.

Another factor to consider, and perhaps calendar for follow up, is what adjustments may need to be made for income tax purposes and cash flow, to reflect an adjustment. If the Jill Trust is determined on audit to have received from inception 10% of the interests in the transferred Entity then 10% of all distributions and other economic attributes should be paid by the Jack Trust to the Jill Trust with interest. Determine what the governing documents provide for and disclose it as appropriate. If the documents are silent it may be advisable to consult with counsel as to whether adjustments are appropriate.

Returning to the prior example, the income tax return preparer might consider the following:

Entity income tax return:

1. Issue Schedules K-1 as follows:

   Jack as to 75% of the Entity
   Jack Trust: as to 25% of the Entity
   Jill Trust: as to 0% of the Entity

2. On each of the Schedules K-1 issued to Jack, the Jack Trust and the Jill trust, a footnote should appear as follows:

   > The preliminary allocation of a 75% interest owned by Jack, 25% interest in the Entity to the Jack Trust and 0% interest in the Entity to the Jill Trust was estimated in accordance with that certain [Assignment Instrument] executed on [original date of the transaction], between, and among Jack and the trustees of each and both of the Jack Trust and the Jill Trust, a copy of which is on file with the Entity as part of its business records.
   >
   > This preliminary allocation is based upon Jack's good faith reliance upon the valuation performed by [third party

valuation professional], a third-party valuation professional, in accordance with Revenue Ruling 59-60 and other regulations and rulings where appropriate. This preliminary allocation is for administrative convenience only. The preliminary allocation of percentages in the Entity will be revised to the actual allocation as necessary once the fair market value of the Entity interests is finally determined for federal gift tax purposes.

3. Each of the individual income tax return for Jack and the fiduciary income tax return for the Jack Trust and the Jill Trust should include a footnote with the language from the Schedule K-1.

Charitable and Marital Mechanisms for Valuation Adjustment Clauses

A common gift tax return oversight is the failure to report charitable gifts.

This is an incredibly common oversight. For almost every gift tax return there is an intent to toll the statute of limitations by meeting the adequate disclosure rules. If any omitted charitable gifts constitute a substantial understatement of gifts, the statute of limitations may be extended from a three-year period to a six-year period.[vii]

This can be doubly problematic where a charity is identified as the non-taxable receptacle in a valuation adjustment clause. In such a case, failure to report charitable gifts, including the potential transfer by operation of the assignment upon final determination of the values of the assets conveyed for gift tax purposes, could result in underreporting of the total gifts made during the year.

For the gift tax return, report the potential charitable gift on Schedule A Part 1, showing $0 gift tax value and $0 basis. Further, the gift tax preparer should reference the specific item number of the potential charitable gift, along with any other charitable gifts, on Schedule A Part 4, line 7.

The preparer should include an explanation with reference to the Assignment instrument and valuation report about how the value of the interest conveyed to the charity will be as finally determined for gift tax purposes. This same language should be incorporated on the individual's income tax return, Schedule A.

Likewise, where the valuation adjustment clause requires any excess to be devised to a spouse or marital trust, the gift tax return preparer should report the potential marital gift on Schedule A Part 1, showing $0 gift tax value and $0 basis. Further, the gift tax preparer should reference the specific item number of the potential marital gift on Schedule A Part 4, line 6.

A Word about GST Exemption and Valuation Adjustment Clauses

Where multiple transactions have occurred during the tax year, a gift tax return preparer must consider how the GST (generation skipping transfer) exemption[viii] might be allocated to various transfers, particularly if the valuation adjustment clause is invoked, as follows:

- The first trust that you certainly want to treat as a GST trust, to which you want to allocate GST exemption, should be elected to be treated as a GST trust. The remaining trusts should have an election not to be treated as GST trusts so that a notice of allocation can better control the manner in which GST exemption is allocated.

- Include a statement of the donor's intention that GST exemption allocations should be done by formula which will change if values are modified on audit.

- To the extent that the donor funded multiple trusts, the gift tax return preparer may wish to specify the order of GST exemption allocation among the various trusts. This could be important as it is not otherwise clear how a limited GST exemption might be allocated. Suppose the client made 2020 transfers to a grantor trust to which a family business interest was transferred, and separately to a simple life insurance trust owning term life insurance. It has been suggested that less than 2% of term life insurance policies are ever collected. So, if there is an adjustment of GST for the overall 2020 transfers it might be preferable to first protect the trust holding the family business even if that is at the expense of the irrevocable life insurance trust ("ILIT") holding term policies. Possible language to consider is as follows:

  In the event that the value of any asset transferred by the Taxpayer to the Trusts reported on Schedule A, Part 3 as referenced below is re-determined for federal gift tax purposes,

> the formula allocation of the Taxpayer’s GST exemption should be allocated in the following order:
>
> 1. The smallest amount of the Taxpayer’s GST exemption shall be allocated to the value of the assets as finally determined for federal gift tax purposes to have been so transferred to the FIRST TRUST as may be necessary to produce an inclusion ratio for GST purposes, as defined in the Internal Revenue Code Section 2642(a), which is closest to, or if possible, equal to zero.
>
> 2. To the extent that the Taxpayer has any GST exemption then remaining after the specific allocation of GST exemption as set forth in #1 above, the Taxpayer directs that the smallest amount of the Taxpayer’s GST exemption shall be allocated to the value of the assets as finally determined for federal gift tax purposes to have been so transferred to the SECOND TRUST as may be necessary to produce an inclusion ratio for GST purposes, as defined in the Internal Revenue Code Section 2642(a), which is closest to, or if possible, equal to zero.

Another consideration might be the reference above to Schedule A Part 3. If the client made a gift to a trust in 2019, for example, that gift might be reported on Schedule A Part 3. However, a note sale to that trust in 2020 may not appear on Schedule A Part 3 but rather it may be disclosed as a non-gift transaction in exhibits attached to the return, or possibly on Part 1 of Schedule A. In such a case, the preparer might opt to modify the reference above to Schedule A Part 3 to indicate that transfers disclosed on exhibits or in other parts of Schedule A would also be covered. That way, if a portion of the sale is recharacterized as a part gift, then any GST exemption remaining could be allocated to it.

When reporting a gift to a grantor retained income trust (GRIT) or other trust includible in the grantor’s estate, you may allocate GST exemption. However, the inclusion ratio is not calculated until the estate tax inclusion period (ETIP) closes. When the ETIP closes, that is, at the moment when the trust would no longer be includible in the donor’s estate if the donor died at that time, the taxpayer may allocate GST exemption to the value of the remainder interest as if the gift had been made on the day the ETIP closes (taking into account any prior allocations).

Reporting 2020 Planning for Married Taxpayers

Throughout 2020, planning professionals considered the importance in crafting plans that emphasized maximum flexibility for their clients as a hedge against the uncertainty of the time. As a result, many married taxpayers engaged in planning that may have differed in 2020 from the type of planning that had been done in years past.

Perhaps One (Not Both) Spouse Made 2020 Gifts

Commentators noted that having only one spouse make irrevocable transfers might avoid the so-called "buyer's remorse" that affected many 2012 last minute estate planning transactions. In the 2020 trust planning environment, assuring access to assets can prove much more difficult than in the 2012 environment for two reasons. First, in 2012, any transfer of more than $1 million preserved exemption. In 2020, transfers might need to be quite substantial before benefit of the temporary exemption is preserved. The reason is that, if (and when) the exemption drops to $5 million (adjusted for inflation) in 2026, the prior use of the exemption may not allow the new (lower) exemption to be used. For example, for a client who made a taxable gift in 2020 of $3.5 million and dies after a reduction in the exemption to $3.5 million, no benefit from the perspective of purely using exemption may have been gained from the 2020 gift. However, growth in the value of the $3.5 million may provide incremental benefit. Further, if GST exemption is allocated to the trust, and/or if the trust is a grantor trust, there may be substantial advantage to having consummated the planning if the trust is grandfathered from changes under discussion that could tax dynasty trusts every 50 or 90 years, or from changes causing inclusion of grantor trust assets in the settlor's estate. Another benefit to this strategy is that the couple is able to preserve one of their lifetime exemptions for subsequent gifting.

The planner should specifically alert the gift tax return preparer about this strategy in order to avoid any mistakes in filing. The gift tax return preparer should confirm that gifts were made from assets that were held by the donor and not jointly by the married couple. No election to split gifts should be made on the gift tax return.

Gift Tax Return Reporting Relinquishment of Interests in Joint Property.

In order to make greater use of the large temporary exemption amounts, some married clients, as discussed above, had only one spouse make gifts to an irrevocable trust. In some instances, the non-donor spouse had to make transfers to the donor spouse or jointly held property had to be divided as to one spouse to then make gifts. In community property states, a transmutation agreement may have been signed to effectuate that. The practitioner completing the gift tax return should be alert to such title changes, and consider disclosing and, possibly including, the documentation effectuating the change in title and transmutation. Evaluate possible issues of step-transaction challenges. Consider obtaining documentation, even though not disclosed on the return, that might be useful to deflect a step-transaction audit. Should the transfer from one spouse to the spouse making the transfers to an irrevocable trust be disclosed on the spouse relinquishing rights? There are pros/cons, as well as uncertainty, as to whether a return should be filed for a spousal relinquishment of interests in a joint account. It is not certain which spouse should disclose this gift on his gift tax return or that the “donor” spouse has relinquished any rights or interests in the accounts. The Form 709 instructions clearly provide that no return is required on gifts to a spouse in general. The instructions provide that a return is required on a spousal gift to make a QTIP election, or if the spouse is not a citizen. The instructions do not say that you cannot file, they merely state that the taxpayer does not have to file. Conceptually, this may not be any different than filing a gift tax return to report a non-gift transaction like a note sale.

It is not clear that filing a return that is not required to be filed will toll the statute of limitations. Thus, even after the intra-spousal transfers are timely and properly disclosed, it is possible that the statute of limitations will not run, leaving the IRS an indefinite opening to challenge whether the spouse has actually relinquished ownership in an asset that was ultimately transferred by the other spouse to a trust. Obviously, one of the risks which this relinquishment of rights in joint spousal accounts raises is the IRS asserting the step transaction doctrine or that the relinquishing spouse should be treated as a co-grantor to the other spouse’s trust, possibly resulting in inclusion of the trust assets in the transferor spouse’s estate.[ix]

Spousal Lifetime Access Trusts (SLATs)

SLAT strategies were used throughout 2020 in order to use exemption and preserve access for a wide range of client wealth levels. Moderate wealth clients may have used SLATs to preserve some exemption, obtain asset protection planning, preserve access and to endeavor to secure GST exemption and grantor trust by grandfathering those benefits from the possible effects of future legislation. At high wealth levels, SLATs may have been used to fractionalize control positions in a family business (and thereby produce valuation discounts) and as the participants in very large note sale transactions (that is a sale to a grantor trust in exchange for an AFR note from the trust).

SLATs might work as follows. Each spouse creates a trust for the other spouse, avoiding the state law creditor and tax reciprocal trust doctrines.[x] This occurs by making the trusts sufficiently different so the doctrines will not apply. The trusts can be created at different times, with different assets and trustees, and with very different terms (e.g. different powers of appointment, different distribution standards, etc.) In one trust, the beneficiary spouse can be entitled to have a lifetime broad special power of appointment, the power to change trustees,[xi] and/or receive annual income distributions or distributions limited to HEMS. In the other trust, the beneficiary spouse would have no entitlement to distributions (perhaps, is not even a current beneficiary), no power to change trustees, and no power of appointment, but could become eligible to receive a distributions only upon exercise by a trusted child with a power to add beneficiaries. Practitioners completing gift tax returns reporting SLATs, especially if they were not involved in the planning process, might indicate to the client that they did not review the trusts and plan for purposes of determining the applicability of the reciprocal trust doctrine. Practitioners might also consider whether they should obtain corroboration for their gift tax file as to the differentiation of each SLAT and the respective planning.

Gift tax return reporting should dovetail the SLAT strategy:

- Spouses may wish not to elect to split gifts in a year when SLATs are funded. To the extent that a spouse's beneficial interest is not limited sufficiently, a gift to a SLAT cannot be split.[xii]

- Assets conveyed should be clearly identified as those which were owned by the donor spouse individually and not joint assets if that is

consistent with the actual facts (if not see the discussion above about prior inter-spousal transfers).

- To the extent that a donor spouse made multiple gifts to a SLAT, the gift tax return should separately identify each such gift and disclose the exact date of each transfer. The gift tax return preparer should be sure to avoid using a catchall "various" notation for the dates when gifts were made to the SLAT.

- In the case of an insurance trust that includes a marital deduction savings clause, the gift tax return preparer may wish to make specific reference to the clause in the gift tax return disclosures. A marital deduction savings clause provides that if any property is included in the grantor's estate (because the grantor dies within three years after transferring a policy on his life to the trust thereby causing the proceeds to be included in the insured's estate or for any other reason) some or all of the proceeds of the policy is held in a qualified terminable interest property trust or is payable to the surviving spouse outright.[xiii]

  Additionally, the gift tax return preparer should report the potential marital gift on Schedule A, Part 1, showing $0 gift tax value and $0 basis with an explanation of how the provision in the trust agreement would work.[xiv] Further, the gift tax preparer should reference the specific item number of the potential marital gift on Schedule A, Part 4, line 6.

Last, Best Option for a Do-Over for the Married Client

Some clients were reluctant to plan and remain so even now that 2020 is behind them. If, as 2021 wears on, the risk of a dramatic change in tax law seems to them less likely, these clients may wish to undo planning that had been completed in 2020, if at all possible. The prudence of that, now that the GA runoff election has concluded and the Democrats can have Vice President Kamala Harris cast a tie breaking vote on tax legislation, might be questionable. The gift tax return may be the last, best option for accomplishing a "do-over" for the reluctant, married client, so long as the underlying instruments were properly drafted.

In order to allow for such a do-over, some attorneys drafted trusts in 2020 with specific language allowing the trust to qualify for an inter vivos QTIP election, as described in Code Sec. 2523(f):

1. The trust must grant to the donee spouse a qualifying income interest for life; and
2. The donor must make a QTIP election on a timely filed gift tax return.

To the extent that the election is made, no gift tax will be due (and no lifetime exemption used), assuming the spouse who is the beneficiary is a US citizen. On the other hand, to the extent that the donor fails to make a timely election as to all or part of the contribution to the trust, exemption will be used and, in effect, a so-called Spousal Lifetime Access Trust (SLAT) will have been created as to that part of the trust.[xv]

This unique opportunity in a time of great uncertainty has allowed such clients to consummate a large gift in 2020 to a "QTIP-able" (eligible for the QTIP election) trust and then evaluate throughout the better part of 2021, until the extended filing date for the 2020 gift tax return (October 15, 2021), whether or not the gift or any part of it should, in fact, use exemption. The donor might consider using a formula QTIP election which fails to make the QTIP election as to the amount of the donor's remaining exclusion available in 2020.

The estate planning attorney should work closely with the gift tax return preparer, financial advisors, and other professionals to ensure adherence to the planning. Lack of consistency and failure to make timely elections that specifically identify the portion of the transfer subject to the QTIP can doom this type of planning.

Finally, several points should be considered with respect to the QTIP-able trust discussed above. First, it may be prudent, regardless of other factors, to be certain that the gift tax return is extended to the final due date in October 2021 to provide as much hindsight as possible to make the decision. Also, practitioners might consider sending a communication to the client/donor confirming the impact of making or not making the QTIP election as to the impact of that on possible exemption use.

Disclaimer "Undo"

Another approach used in some 2020 trust planning was to incorporate a mechanism into the trust document permitting a beneficiary to disclaim. That mechanism may have made one particular beneficiary the primary beneficiary and further provided, in contrast to traditional disclaimer mechanisms, that if that beneficiary disclaimed all assets would revert to the donor thus unwinding the transaction. Even if the trust agreement was silent it may be possible under state law for the trustee to disclaim. Practitioners should confirm whether the transaction incorporated a disclaimer safety valve and the terms of that provision. Further, it may be advisable not to file the return until after the date the time period for the disclaimer has passed. Finally, practitioners might consider requesting confirmation in writing from the person or persons holding the disclaimer right that they have not exercised the disclaimer. Without confirmation, how can the preparer be certain that the disclaimer was not exercised?

Reporting Note Transactions

Some clients had no appetite for making substantial wealth transfers in 2020. However, they may have revisited some of their older planning and took advantage of the historically low interest rates by refinancing older intra-family loans or making new intra-family loans. Other clients used note sale transactions to lock in Covid valuation discounts and lack of marketability and control discounts before those might be restricted or eliminated by future legislation.

Substituting Higher-Interest for Lower-Interest Notes

For example, assume that parent sold assets to a trust several years ago in September 2015 and the required interest rate was 2.64% and in October 2020, the long-term rate was 1.12%. If a new note at the new rate was substituted for the old note at the old rate, a substantial reduction in leakage back into the parent's estate might be achieved. Practitioners considering the array of planning options available to clients may have engaged in planning to substitute low interest notes for higher interest notes. Practitioners preparing gift tax returns may wish to disclose these types of transaction on 2020 gift tax returns as non-gift transactions. Failing to do so might result in the statute of limitations on gift tax audit not tolling (there may be income tax issues if the borrower was a non-grantor trust that warrant consideration as well). If the practitioner completing the gift tax return becomes aware of such a note substitution transaction, in addition to

disclosing that transaction (if that is the decision) the practitioner might consider alerting the client to some of the tax risks and issues with such a transaction if the practitioner was not involved in the actual transaction to have done so at that time.

While note refinances were not completed to address the risk of future transfer tax changes, they were common in 2020 because of the historically low interest rates. Therefore, practitioner should expect to see many of these transactions.

Assume, for example, that the original note arose from a sale by a parent of family business interests to a grantor trust. This non-gift transaction could be reported on Form 709, most likely on Schedule A Part 3, with all relevant documents attached as exhibits. The following documentation and steps might be available to substantiate the note swap by reporting it on a timely filed gift tax return:

- Original Note which includes a provision allowing the debt to be prepaid at any time without penalty. To the extent that the original note incorporated restrictions on prepayment, the gift tax return preparer should include any documentation resolving this restriction as an exhibit to the gift tax return.

- New Note. The new, fully executed promissory note should be included with the gift tax return.

- Modification of Pledge and Escrow Agreement. If the original note arose from the sale of assets by the parent to the grantor trust, the gift tax return preparer may wish to include as exhibits both the original pledge and/or escrow agreement as well as the modified pledge and/or escrow agreement (or perhaps a modification agreement that modifies all sale documentation as to the refinance of the note). Both should be fully executed by all relevant parties.

- Novation Agreement. A novation agreement could be signed by both the maker of the note as well as the lender and could confirm the agreement on cancellation of the original note. The gift tax return preparer may wish to include any such Novation Agreement as an exhibit to the gift tax return.

- Other Documents. The gift tax return preparer should reach out to the planner to obtain copies of all other documentation that had been executed to address the nuances of the original transaction giving rise to the original note and to finalize the substitution of the promissory note between the parties.

Possible Gift Tax Disclosures for Certain Note Transactions

If a client was engaged in a loan transaction, generally consideration should be given to disclosing the loan to toll the statute of limitations on audits of the loan as a potential gift. While some practitioners are uncomfortable using a loan to fund the borrower making a gift, some clients engaged in these transactions in 2020 and practitioners may wish to be aware of some of the disclosure nuances.

In some situations, clients who have used up their exemption may be looking to help their children use theirs. In those cases where the adult children do not have sufficient resources to make gifts to use their exemptions, the older generation (G1) may have loaned assets to the younger generation (G2) so that G2 can take advantage of G2's remaining lifetime exemption. Practitioners need to be alert to the possibility of these transactions to be certain that appropriate gift tax return compliance reporting is addressed. By making a long-term loan using an interest rate that matches the applicable federal rate (the "AFR"), G1 may be able to provide the use of money to G2 without making a taxable gift, although this transaction may not be without risk.

If G2 wanted to make gifts upon receipt of funds borrowed from G1 in order to use up G2's lifetime exemption, the practitioner may have considered additional safeguards to avoid implication of the step transaction doctrine which holds that "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result … will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation."[xvi] Some of these transactions, for G1s transfer to G2 to be respected as a loan may require outside guarantees, which might come from a family dynasty trust of which G2 is a beneficiary. The planner and the gift tax return preparer should discuss how best to make the necessary disclosures in order to reduce the risk that the transaction will be recharacterized as a gift from G1 to G2's intended beneficiaries.

On G1's 2020 gift tax return, G1 should include a copy of the Note. For any Note that was secured by an existing dynasty trust guarantee that had

been previously set up by G1 (or other family members) for the benefit of a class of beneficiaries that might include G2, the elements of this part of the transaction might be disclosed on G1's gift tax return, with copies of the Security Agreement and Dynasty Trust instrument, and any other relevant documentation. G1 should report interest income received from G2 on a timely filed income tax return. For context, the annual interest due on a loan of $1 million with a 1.12% interest rate (the October 2020 long-term AFR) would only be $11,200.

The gift tax return preparer for G2's 2020 return should be sure to meet the adequate disclosure rules for the gifts made by G2, including all documentation to support the gift. If G2 had made gifts to trusts for the benefit of individuals who are not the natural objects of G1's bounty in order to hedge against a step-transaction challenge, the gift tax return preparer should be sure to specify the individual beneficiaries of any such trust in the description of the gift on the G2's gift tax return.

Loans from G1 to G2 may appear simple to implement but it is important for the parties to follow loan formalities. Any such intra-family loan should be memorialized in a Promissory Note instrument. Both parties should sign it, possibly in the presence of a Notary Public, if available. Payments should be made in accordance with the note instrument and there should be economic consequences if payments are not made timely, such as a late payment penalty.

All such transactions might be disclosed on timely filed gift tax returns in order to avoid government scrutiny and a possible recharacterization of the loan as a gift.

Avoid Common Form 709 Errors

Gift tax return preparers should also be wary of some of the more common mistakes/oversights that can put 2020 planning at risk by inviting additional scrutiny.

Some of the most common mistakes/oversights are:

1. Incomplete/incorrect summary of previously filed returns and exemption amounts used reported on Schedule B of the Form 709,

United States Gift (and Generation-Skipping Transfer) Tax Return. Practitioners tackling a Form 709 should first obtain copies of all previously filed returns. Information from those returns will not only be required to be listed on the current filing, but it will be critical to ascertaining a range of positions taken and whether issues exist with past reporting. For example, if a gift to a trust was reported in a prior year, was the trust instrument appended to the return? Was sufficient information about each transaction attached to comply with the adequate disclosure regulations? Was the allocation of GST exemption handled properly? Were there front-loaded gifts to Code Sec. 529 plans that could affect current reporting?

2. Reporting gifts in the wrong section of Schedule A. Sometimes practitioners might report gifts as outright gifts when in fact there are GST implications. Each transfer must be reported in the part of the form corresponding to its category, and too often practitioners are not cautious about properly characterizing where these are reported. Gifts subject to gift tax can include any transfer by gift of real or personal property, whether tangible or intangible, made directly or indirectly, in trust, or by any other means. Gift tax applies not only to the gratuitous transfer of any kind of property, but also to sales or exchanges, not made in the ordinary course of business, where the value of the money (or property) received is less than the value of what was sold or exchanged. Gifts subject to GST tax include lifetime or inter vivos transfers that are “direct skips.” An inter vivos direct skip is a transfer made during the donor's lifetime that is subject to the gift tax and made to a skip person (*e.g.*, a grandchild, or a trust solely for grandchildren). Many gifts, however, are not direct skips, *e.g.*, a gift to a trust that includes children (who are not skip persons), as well as further descendants (e.g., grandchildren) who are skip persons. An outright gift or a gift to a trust with no GST potential is reported in Part 1; a gift to a skip person, whether an individual or a trust for the benefit of only skip persons is reported in Part 2; and a gift to any other trust is reported in Part 3, together with an indication of whether GST exemption is to be automatically allocated to that gift. To run the statute of limitations, sales that not intended to be gifts should be reported in an attachment with all of the elements of adequate disclosure; whether to cross-reference this on Schedule A or merely attach it is a matter of judgment depending on the circumstances.

3. Schedule B, Gifts from Prior Periods, is commonly an incomplete summary of the prior gift tax returns filed by the client. This schedule is an important part of the gift tax return because the total of the taxable gifts from this schedule carries to page 1 of the return and is included in the gift tax computation. In addition, when a client passes away, this summary of gift tax returns filed is an important roadmap in knowing how many gift tax returns need to be included with the federal estate tax return. It is important to get copies of all prior gift tax returns filed by a client for whom a gift tax return is being prepared so that Schedule B can be correctly completed. If the client is not certain of what years they have filed, Form 4506, Request for Copy of Tax Return, can be filed with the IRS to obtain copies of gift tax returns that they have on file for the taxpayer.

4. Another reporting area in which the gift tax return preparer can cause confusion is in the reporting of transfers made to Code Sec. 529 plans when the election to treat the transfer as made ratably over a five-year period is made. The preparer must make an affirmative election on the gift tax return for the year that the transfer into the plan is made and keep in mind when reporting gifts to that child for the next four years that the client has already utilized some or all the annual exclusion amount with the previous Code Sec. 529 transfer. The ratable portion of the Code Sec. 529 gift should be shown on the future gift tax returns, until the five-year period has expired, to avoid losing track of this previously utilized amount of annual exclusion.

GST Form 709 Common Oversights

The GST tax is complicated, and many of the rules not intuitive. Further, with the growth of the estate tax exemption to $5 million inflation adjusted, and more recently to $10 million inflation adjusted ($11.58 million for 2020), many practitioners do not have much occasion to delve into GST issues. Caution is in order in addressing the many GST issues that can be reflected on what might otherwise seem to be a “simple” Form 709. Consider some of the following:

1. Incorrect/lack of GST exemption allocations. The GST exemption for 2020 was the same amount as the lifetime gift tax exemption: $11,580,000. You want to utilize this exemption for transfers that provide current or future distributions to or for the benefit of skip

persons. The consequences of these mistakes can be severe (for example, a flat 40-percent GST tax being due on the value of a trust that was not properly covered with GST exemption) and the opportunities for remedying the mistake, if available, can also be costly.

2. A common mistake is netting out the annual exclusion amount before applying GST exemption when the annual exclusion may only apply for gift but not GST tax. The rules differ: Code § 2642(c) provides that the GST annual exclusion applies to gifts to a trust only if the trust is for only one beneficiary and is included in that beneficiary's estate upon that beneficiary's death.

3. Incorrect elections or acknowledgement of GST automatic allocation. Code § 2632(c)(3) allocates GST exemption automatically to an "indirect skip," which means a transfer to a "GST trust." The Code Sect. 2632(c)(3)(B) definition of "GST trust" can be confusing. Rather than spending any time analyzing that provision (and risking a mistake), practitioners might consider affirmatively electing under Code Sect. 2632(c)(5) to treat transfers to a particular trust as an indirect skip. That is to say, the practitioner might report the transaction as a transfer to a GST trust and then include an affirmative GST election, perhaps worded as follows:

   While Taxpayer believes that John's Dynasty Trust" is a GST Trust, in the event that such trust is not a GST Trust, the Taxpayer hereby affirmatively elects to have GST exemption allocated to the transfers to such trust….

   Other practitioners might prefer instead a simpler statement that a particular trust is elected to be a GST trust and not use the precatory language suggesting that it was believed to be a GST Trust.

4. Some preparers affirmatively opt out of automatic allocation and allocate GST exemption via a notice of allocation. If a future gift tax return is late, a late allocation of GST exemption can be time-consuming. In most cases, one should consider opting to allocate GST exemption automatically and then later opting out of allocating GST exemption if that is desirable.

5. When preparing a notice of allocation, consider whether to include language that covers the possibility of the value of the gift being changed upon audit so that the amount of GST exemption allocated fluctuates with that change in value. Even though some of these GST elections we've discussed (electing to be a GST trust, opting out of automatic allocation) can be made once and remain in effect going forward for that respective trust, it's helpful to list each trust to which transfers are being made and state affirmatively what GST elections have been made not just for tax reasons, but as a form of provenance and clarity for others in the future who may be working to discern and decipher the trust. Providing minimal information is counterintuitive and can breed frustration. Be clear and transparent on the steps you take/elections you make in this area.

Disclosure and Form 709 Common Oversights

When filing a gift tax return, practitioners might attach as much documentation as possible to minimize the chance of the IRS coming back with questions. You want to adequately support what is reported on the return, particularly values, or the statute of limitations for that return will not toll. Reg. § 301.6501(c)-1(e) and (f) outlines what is required to be provided for a gift to be considered adequately disclosed. Read those regulations in detail. Some tips:

- The adequate disclosure regulations require the appraisal to list the exact number of shares, units, or percentage interest transferred and value them as of the date of the transfer. Any appraisal done before the transfer date generally needs an update letter from the appraiser referring to the full appraisal and updating it for the required information.

- The adequate disclosure regulations require either a copy of the trust or a sufficient summary of the trust's terms. Given that the IRS might argue that a summary was insufficient, attaching a copy of the trust is the most practical approach. Although the gift tax return instructions do not require a copy of the trust agreement if it was attached to a prior year gift tax return, those instructions determine merely whether the return was filed in good faith and do not purport to supersede the adequate disclosure requirements. Therefore, we recommend attaching a copy of each trust agreement each year, even if a copy was attached to a prior return.

Lack of sufficient amount of supporting documentation included with the gift tax return to start the statute of limitations and/or avoid follow-up communications from the IRS. An approach that might be useful it to create a table of contents for all exhibits to be attached. This can be a great safety check to makes sure any important disclosure is not overlooked. It also can facilitate the collection of documents, make handling an audit easier and more efficient, and more. Before creating the table of contents, consider how it should be organized. If a client has a simpler gift tax return with just gifts to a single trust, that might be easy. If there are multiple complex note sale transactions, defined value mechanisms, GRATs and more, it might be easiest to organize exhibits by trust or donee. In other instances, the transactions themselves are so complex that organizing exhibits by transaction may be more useful. In all events organizing an exhibit list will improve the likelihood that all documents necessary for adequate disclosure have been included.

As the returns get more complicated, a year or two later, having the transactions explained and the supporting documentation included as exhibits to the return makes your process easier and removes a fair amount of guesswork in trying to remember the prior year transactions. It's not only about meeting adequate disclosure requirements so that the statute of limitation runs, but also to assure that, if an agent comes in with a “kitchen sink” audit letter, asking for everything, and the answer to 90 percent of the questions is “See exhibit A, B, or C,” it will set a different tone for the audit. Or – better yet – if the return has everything an examiner might request and demonstrates that the taxpayer was trying to comply thoroughly, the IRS may decide to accept the return as filed and leave the client – and you – alone.

Conclusion

Gift tax returns are often incredibly complicated with layers of issues, technical decisions, and disclosure requirements. 2020 created additional and sometimes novel gift tax reporting considerations.

This discussion underscores the imperative for collaboration among the estate planning practitioner and the tax preparer. Disclosures should be carefully constructed in order to bolster the client’s position against a challenge by the IRS as to the operation of the valuation adjustment clause. The gift tax return preparer should seek counsel’s review and

comment prior to finalizing the gift tax return for filing with the IRS. This will likely increase the costs of preparing and filing the gift tax return, but it will be well worth it.

Gift tax return preparation practice should be viewed by practitioners as the danger that it is. If a client will not permit you to handle a Form 709 filing in the manner you as a professional believe necessary, pass on accepting the work. Familiarize yourself with gift tax guidelines and rules carefully to ensure nothing is overlooked.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Joy Matak

Steven B. Gorin

Martin M. Shenkman

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CITATIONS:

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[i] IRC Sect. 6501(c)(9).

[ii] This newsletter is not intended to be a comprehensive guide for completing gift tax returns.

[iii] Perhaps one of the best checklists available was created by Stephanie Loomis-Price, ACTEC Fellow, and is available online at: https://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2014/adequate_disclosure_checklist.pdf.

[iv] *McCord v. Commissioner*, 461 F.3d 614 (2006), *rev'g* 120 T.C. 358 (2003); *Estate of Petter v. Commissioner,* T.C. Memo. 2009-280; *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 13, (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009). For key excerpts from those cases and commentary on such issues, see Gorin, III.B.3. Defined Value Clauses in Sale or Gift Agreements or in Disclaimers, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," available by emailing the author at sgorin@thompsoncoburn.com.

[v] *Nelson v. Commissioner*, T.C. Memo 2020-81.

[vi] Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017).

[vii] Code section 6501(e)(2).

[viii] "GST exemption" is a technical term defined by Code § 2631(a).

[ix] IRC Sect. 2036(a).

[x] Steiner and Shenkman, "Beware of the Reciprocal Trust Doctrine," Trusts & Estates magazine (April 1, 2012).

[xi] Within Rev. Rul. 95-58, 1995-2 CB 191 safe harbor.

[xii] Stanley L. Wang, T.C. Memo. 1972-143; Max Kass, T.C. Memo. 1957-227; Rev. Rul. 56-439, 1956-2 Cum. Bull. 605. Whether to split gifts in a

year in which gifts are made to a SLAT requires further analysis which is beyond the scope of this article.

[xiii] Note that great flexibility will be available if a QTIP trust is used. The estate of the insured spouse would have 9-15 months to decide the extent to which the marital deduction should be claimed.

[xiv] Blattmachr, Zeydel & Gans, "The World's Greatest Gift Tax Mystery, Solved," 115 Tax Notes 243 (Apr. 16, 2007), expresses concern whether a QTIP election can be made on a gift tax return when the election is purely contingent. Practitioners might consider having some gift be made to the QTIP trust or to make the trust a general power of appointment marital deduction trust.

[xv] Acknowledgement to Professor Jerome B. Hesch, Esq. and Alan S. Gassman, Esq., from Steve Leimberg's Estate Planning Email Newsletter Archive Message 28130-Aug-20, Alan S. Gassman, Jerome B. Hesch & Martin B. Shenkman, "Biden 2-Step for Wealthy Families: Why Affluent Families Should Immediately Sell Assets to Irrevocable Trusts for Promissory Notes Before Year-End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-Tip Trusts.".

[xvi] FNMA v. Commissioner, 896 F. 2d 580, 586 (D.C. 1990), cert. denied, 499 U.S. 974 (1991) (citing Kanawha Gas & Utilities Co. v. United States, 214 F.2d 685, 691 (5th Cir. 1954).