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to Common Issues

Gift Tax Returns Are Simple, Why Are You Saying It Will Be So Involved?

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Introduction

Too often clients (and sometimes even a few practitioners) view gift tax returns as a rather simple matter. After all, the form issued by the IRS to report gifts is not particularly long (only 5 pages!) and on the face of it, filling out a gift tax return might not be viewed as a particularly involved matter. However, that apparent simplicity belies the incredible complexity of planning, completing and following up on a gift tax return. The "simplistic" view of the gift tax return also overlooks several potentially important application of the gift tax preparation process.

Ancillary Tasks That Might Be Addressed in Gift Tax Return Preparation

There are a number of tasks that can be important to the overall plan that might be addressed as part of the gift tax return preparation process.

Review of the Transfer Tax Planning Documents as Part of Gift Tax Return Preparation

Inter-vivos transfers can range from a simple cash gift outright to an heir to complex combinations of gift, generation skipping ("GST"), and even non-gift transfers. As transactions progress along the continuum from simple to more complex, the importance of the gift tax return process, not just to meet IRS reporting requirements, but to serve as a review of the previously completed planning grows in importance. It is common that when this broader view of gift tax return preparation is taken, important gaps in planning or documents might be identified. Common issues that might be identified are:

- Improperly prepared assignment documents. Some irrevocable trusts incorporate a mechanism to divide and allocate most of a gift transfer made after a specified date to an incomplete gift trust. This approach incorporates a gift and GST tax saving mechanism into the trust instrument itself, in contrast to a *Wandry* clause, as an example, that may be embodied in the assignment and transfer documents. If the gift tax return preparer identifies this mechanism, the assignment and other transfer documents often need to make express reference to the mechanism in order to avoid its application when a gift is made past the date set forth in that mechanism in the trust instrument. These later gifts have become common as clients endeavor to capture and secure the large inflation adjustments to the exemption amounts that may not have been anticipated when the instrument was first crafted.
- It is common to identify missing documents that, if executed, might further support the planning. For example, some practitioners recommend that amended and restated governing documents be created and signed after the transfer of entity interests to reflect the donee (e.g., an irrevocable grantor trust) as a shareholder or member. Amidst the frenzy of closing a large transaction, the need for these ancillary documents might simply be overlooked. While the gift tax return preparer may feel that the assignment of interests to the donee suffices to meet adequate disclosure requirements, others may feel otherwise especially in the wake of the *Smaldino* and *Sorensen* cases, wherein the Tax Court suggested that such entity documents would have bolstered the taxpayer's position. These cases and their implication to planning are discussed briefly below. The gift tax return preparer may have a great vantage point to review the transaction as a whole and discuss with the advisory team whether such documentation could be made effective as of the date of the original transaction though executed contemporaneously with the preparation of the gift tax return. Perhaps such materials might be created and executed before the gift tax return is completed so that they might be included as exhibits to buttress the planning and otherwise satisfy adequate disclosure requirements.
- A gift tax return preparer may identify scrivener errors in the documents. For complex transactions with scores of documents, it is easy, and should not be unexpected, for such "nits" to occur. For example, if the client changed the dollar value or percentage interests of any transfers at the last minute, confirming changes may have been made to most but not all of the documents. Occasionally, an error is made in the term of a note that was intended to be, for example, a mid-term note but the duration of the note accidentally exceeded nine years, thereby becoming a long-term note with a different interest rate. While different practitioners may address each such situation differently, the gift tax return preparation process presents a unique opportunity to identify and correct any such issues before the transactions are disclosed to the IRS and/or creditors. Taking reasonable corrective action before a creditor or the IRS even knows there is an issue has to render a better result for clients.

Identifying Steps for Administration of the Plan

Most estate plans, even quite simple ones, require ongoing follow up administration to succeed. For example, even a simple life insurance trust may require annual gifts, Crummey notices, gift tax return filings, a statement on the gift tax return affirmatively addressing GST implications, etc. A more complex transfer plan could entail much more administrative attention in order to

achieve its objectives. By way of example, a note sale with periodic note payments may require income tax reporting to reflect a defined valuation mechanism incorporated into the transfer and monitoring trust cash flows to assure sufficient liquidity to make note payments. The process of preparing gift tax returns provides an ideal opportunity to address compliance requirements and identify the steps that should be considered in annual/periodic administration of the plan. If a checklist for administration had been created when the plan was initially implemented, reviewing and revising that checklist could be incorporated into the return preparation process. To the extent that a checklist had not been created, such a checklist should likely be created during the process of preparing the gift tax return.

Organizing Transaction Documents

For many transactions reported on a gift tax return, it can be advantageous from a plan administration perspective to collect and organize all transaction documents in an organized fashion. If that had not been previously done, the exhibit listing for the gift tax return may provide a template for doing so. In many instances, there will be documents that are not appended to the gift tax return as exhibits, and hence not reflected in the exhibit list for the return, that should be organized and saved. Thus, the gift tax return exhibit list may be a useful starting point to collate all transaction documents.

Other Tax Compliance Steps

When preparing the gift tax return, it may be helpful for the preparer to identify other tax compliance that may be affected. For example, if the transfer transactions involved valuation adjustment mechanisms, how might those preparing entity and other income tax returns report such transactions? This could be an important component of the planning and the gift tax return preparer might help backstop the entire plan by identifying and communicating such points to those responsible for the income tax returns. For example, where a fixed dollar value of equity interests is transferred to a trust, the income tax returns for the entity and the trust should reflect that the ownership interest and allocation of income is estimated at a particular percentage until values are finally determined for gift tax purposes.

It could be an essential part of the plan to inform income tax preparers about valuation adjustments and advise them about how the operation of such adjustment might affect the allocation of income among owners of the entity. If, for example, the same accounting firm is preparing the gift tax return and handling other tax compliance matters for the client, the trusts and estates partner might generate an internal memorandum to a flow through entity partner informing her of these matters and perhaps even providing the language to be used on the statements to be attached to an income tax return.

Adherence to Formalities is Critical to Plan Success

In general, practitioners know that respecting the formalities of transactions is critical to the success of planning. Ensuring that clients abide such formalities might be a different story, as illustrated in several recent Tax Court cases.

The *Smaldino* case is viewed by some as primarily a step-transaction case.[2] However, the case emphasized the importance of observing formalities in order for a plan to be respected. So, while the case was a taxpayer loss in an indirect gift situation, the lessons are broader. Many of the issues that tripped up the taxpayer in *Smaldino* were points that might have been addressed as part of the preparation of the gift tax return:

- consistent reporting of the transaction on income (*e.g.*, K-1s) and gift tax returns;
- properly dating all documentation (*e.g.*, gifts and other transfers);
- updating entity documentation (*e.g.*, an amended and restated operating agreement reflecting each ownership change);
- complying with requirements of an entity's governing documents (*e.g.*, a document confirming manager approval to a transfer);
- having sufficient time between steps to help negate a step-transaction challenge;
- having and corroborating economic substance to transactions;
- having entity documentation that corroborates the estate planning transfers made, and more.

Many of these points would require involvement of the client's attorney or other advisors to address but a knowledgeable gift tax return preparer might be well situated to identify and raise issues with the advisory team.

In contrast to the *Smaldino* case that was a taxpayer loss, the *Levine* case was a taxpayer victory.[3] At its core, the *Levine* case was an intergenerational family split-dollar estate tax case, but the lessons apply broadly to estate planning generally, and to highlights opportunities to use the gift tax return preparation stage of planning in a broader context. The Court in *Levine* lauded the taxpayer for the detailed documentation explaining, among other things, the planning to be done, the planning using only "excess" assets, and the careful completion of all legal documentation to support the plan, with careful attention to the language used.

With the pressure of using the temporary exemption before it is cut in half in 2026 (as the current law now provides), some taxpayers might be motivated to make transfers, e.g., to non-reciprocal spousal lifetime access trusts (SLATs), with a significant percentage of their overall wealth. One of the messages from the *Levine* Court was that transfers should not impinge on the resources the taxpayer requires to maintain their lifestyle expenses. If the gift tax return preparer sees relatively large transfers, they might opt to inquire if any financial analysis or forecasting was done to corroborate that the taxpayer had sufficient resources remaining to support the transfers made. Such an analysis might then become an integral part of the gift tax return process which can more broadly include assuring that the preparer understands the transaction and is professionally comfortable with it. If the client's estate planning attorney quarterbacked the transaction, the tax preparer might be well positioned to take a fresh look at the entire transaction.

More recently, the *Sorensen* case emphasized the importance of proper documentation to support a defined value transfer.[4] In *Sorensen*, the corporation failed to reflect the nature of the defined

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[2] Smaldino v. Comr., T.C. Memo. 2021-127 (November 10, 2021).
[3] Levine Est. v. Comr., 158 T.C. No. 2 (February 28, 2022).
[4] Sorensen v. Commissioner, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022).

value transfer in its stock ledger, specifically the fact that the shares owned by the individual taxpayer and the trust could be adjusted once values were determined for gift tax purposes. The *Sorensen* court also faulted the taxpayer for omitting any mention of the defined value transfer and adjustments that might be required when the owners later sold a specific number of shares to a third party in an arms-length transaction. A gift tax return preparer might inquire about and review the underlying documentation in order to confirm that corporate documentation is consistent with the plan.

A Message To Clients: The Answer to the "Simple" Question

Hopefully, these cases have illustrated that the process of preparing the gift tax return is an important final step to a successful estate plan. The advisory team should emphasize that taking a simple or superficial perspective of the gift tax return preparation process could short-change their planning. A more comprehensive and detailed effort at gift tax return preparation may well identify foot faults that occurred when the plan was completed or important follow up steps that might bolster the plan. It is true that such attention to detail by the gift tax return preparer might complicate the preparation of a seemingly "simple" gift tax return and inevitably result in additional tax preparation fees. However, using the gift tax return preparation process to identify and correct as many of the "nits" in the plan as possible is the safer and recommended approach that might preserve the planning and save tax dollars in the long run.

Gift Tax Returns - General Cautions

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 many mistakes. Seasoned gift tax return preparers often develop checklists and preparation templates and have familiarity with the nuances of gift tax return preparation which may be harder for preparers who only occasionally prepare them.

With all of the layers of uncertainty and nuances with gift tax return preparation, a gift tax return preparer should not assume that reporting any transfer is simple or obvious. This is particularly true for recent tax years when the fear of impending tax law changes created a rush of planning. The sheer volume of clients seeking planning services during these uncertain times could overwhelm estate planners.

There is reason to expect that changes could be on the horizon. Perhaps the Biden Administration could gain traction through Congressional negotiations over the debt ceiling to change tax laws or possibly use administrative powers to accomplish some of his Greenbook priorities. Of course, if nothing changes, the lifetime exemption will be cut in half on January 1, 2026 upon the sunsetting of the Tax Cuts and Jobs Act. For planning done under such conditions, it is likely even more important to have a robust gift tax preparation process, which includes a deeper review of all transaction documents.

Clients Should Understand Why Gift Tax Returns Are So Important

It is generally unusual for clients to consummate gifts that intentionally generate gift tax.[5] Few taxpayers are willing to intentionally incur a gift tax.

When no gift tax is due, tax returns may seem somehow less urgent. Nothing could be further from the truth. The 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,[6] 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 (GST) 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 Gift Tax Compliance

Planning in 2020-2021 was in some ways different from planning done in other 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 tax laws did not change as feared. Similar provisions permitting "backsies" may arise in planning leading up to 2026 exemption reduction. Some of the techniques to provide second looks at planning may continue to be incorporated into planning post 2020-2021 now that some practitioners have become comfortable with the techniques involved. These techniques might include:

- Incorporate a disclaimer provision into the trust instrument so that a designated beneficiary can disclaim assets transferred on behalf of the entire trust. If that disclaimer is acted upon, the assets revert to the transferor. We do not address the efficacy of such a technique but rather raise it as a point that might require specific disclosure on the gift tax return. Also, if this type of mechanism is used, the gift tax return reporting a completed transfer might need to await the tolling of the nine-month period during which the disclaimer can be effected. Arguably, until the time for a qualified disclaimer has passed, there may be no certainty as to whether the transfer in fact occurred.
- Another approach is to have a gift made to a trust that could qualify for the gift tax marital deduction if QTIP treatment is elected on the gift tax return. If the client, at the time of filing the return, has determined that the gift should be permitted to be completed, then no QTIP election should be made.

In all instances, the practitioner preparing the gift tax return must understand the mechanism and confirm the client's intent. The challenge for practitioners is to ensure that the specifics of each

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[5] Generally speaking, advisers may advise elderly or infirm clients to make gifts that result in a gift tax, given that the gift tax is tax exclusive while the estate tax is tax inclusive. For example, it might be advantageous for a client to pay a gift tax at the rate of 40% and having that gift tax paid excluded from their estate if they survive three years. Those returns, however, will likely be few in number.

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

transaction are disclosed adequately on timely filed gift tax returns so that the statute of limitations is tolled. Sometimes this work will be done by gift tax return preparers who may not have been part of the original planning discussions. That could be particularly problematic if the gift tax return preparer had been excluded from the planning process, and the client tries to limit communications between professionals to hold down the cost of the gift tax return.

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.

Valuations

Recent Valuation Cases Hold Lessons for Gift Tax Return Preparers

There have been a number of recent valuation cases, some of which are briefly reviewed below. The IRS is scrutinizing valuation issues more closely so practitioners should be cognizant when reviewing appraisals and assembling attachments to the return.

In a Chief Counsel Advisory opinion, the taxpayer valued an asset gifted based on old appraisal that was done before five offers to buy the company were received.[7] The IRS not only nixed the valuation but said that it would not respect the valuation adjustment mechanism otherwise permitted to the GRAT, the gift was made to. The GRAT itself seemed to be properly structured, but the appraisal was 7 months old. How bad is 7 months? Given that between the date of the appraisal and the funding of the GRAT the company received many offers to purchase it, key facts were apparently intentionally ignored by the taxpayer. The CEO/Taxpayer knew at the time the company was being shopped but failed to inform the appraiser. The appraisal was also prepared for Section 409A purposes. The IRS argued that the retained interest in the GRAT was not a qualified annuity interest under § 2702 of the Code because the Taxpayer used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

The Chief Counsel pointed out that "…. intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion-dollar range." It is not clear that this is a proper reading of the Regulations, but it certainly is cause for pause. GRATs are the "original" formula clause. The Regulations contain an adjustment mechanism if the annuity payment is specified as a percentage of the value of the asset not a fixed

[7] CCA 202152018 Release Date: 12/30/2021.

dollar amount. Under Atkinson v. Commissioner, 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002) a charitable remainder trust (a "CRT") was challenged for not complying with the terms of the Regulations. GRAT Regulations are similar to CRT Regulations. Based on an application of *Atkinson*, the GRAT failed. The GRAT annuity treated as not being a qualified interest under Section 2702 because of undervalued appraisal (by analogy to Atkinson).

Some have read the CCA as suggesting that a valuation that is 7 months old is not acceptable. That may be, but perhaps the real issue in the CCA was that the taxpayer did not make proper disclosure of key facts to the appraiser. The taxpayer knew that there was a significant development subsequent to the appraisal and he hid that. So, while practitioners might question the validity of a stale appraisal, the bigger issue is proper disclosure.

Be sure if you have an asset appraised disclose all relevant facts to the appraiser and perhaps the appraiser should disclose those facts in its report. Even if the harsh result of this CCA is overturned, it is a clear warning from the IRS not to use egregious knowingly wrong valuations and rely on a valuation adjustment mechanism to keep you out of tax hot water if you're audited. Should practitioners get a rep or comfort letter from the client as to no material change from date of appraisal to date of transfer? Another consideration is should GRATs continue to be used as receptacles in Petter or Christenson type spillover adjustment mechanisms? Perhaps a belt and suspenders should be used on funding GRATs with a defined value mechanism on the assets gifted to the GRAT so that the adjustment occurs outside the GRAT mechanism. Another consideration for planners is whether GRATs should continue to be used in valuation adjustment spillover mechanisms as a receptacle. Might a DAF or incomplete gift trust now be better options than a GRAT?

In another case the taxpayer was a key executive who knew the public company had offers to merge. He disregarded those circumstances and valued the stock at the mean between the high and low value for the day which is how the tax Regulations say stock should be valued. The executive believed that his gift of publicly traded stock was required to be valued following the average high/low value rule set out in Treas. Reg. §25.2512-2(b)(1). The IRS objected but it appears that the case was settled. The IRS seems wrong on this one but notice the pattern of valuation challenges.[8]

Finally, in another case the taxpayers made a gift of life insurance and had a well-known appraisal firm value the policies which was done based on the secondary market for life insurance.[9] But the tax regulations require use of the interpolated terminal reserve value plus unexpired premiums. Reg. § 25.2512-6(a). This is not a simple one. The regulations are old, don't contemplate the policy type involved. But the policy involved was also outside the parameters of the typical policies sold in the secondary market. Was that expressly addressed in the appraisal? Insurance valuations should probably include a Form 712 and an analysis of those numbers by an insurance expert.

Specific Considerations for Gift Tax Return Preparers

[8] Daniel R. Baty v. Comm'r, Docket No. 12216-21.
[9] Dematteo v. Comm'r, Tax Ct. Dkt. No. 3634-21 (July 21, 2022).

- Confirm whether the law provides for a special valuation mechanism for the assets reported on the return, e.g., the life insurance in the above case.
- Might it be advisable for preparers of gift tax returns to have clients sign a statement corroborating that there are no known material facts which the client did not disclose to the appraiser? Having such a document may protect the practitioner if the facts like the above CCA should occur.
- Asset values must be disclosed in a way that satisfies the adequate disclosure regulations.[10]
- 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, **<u>or for any other reason</u>**, 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].

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[10] 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.

Valuation Adjustment Clauses

Some practitioners have made the use of *Wandry* or other valuation mechanisms routine in most transfers that might create a transfer tax cost if challenged. Other practitioners prefer not to use valuation adjustment mechanisms under a variety of theories, e.g., that it will bring audit attention to the transaction. Perhaps the most popular valuation adjustment mechanisms is 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 valuation cases.[11] 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. Some commentators have suggested in the wake of the Sorensen case noted above that Wandry valuation adjustment mechanisms should not be used, as that was the mechanism struck down in Sorensen. Instead, they suggest, a Petter or Christenson type mechanism should instead be favored. Many commentators strongly disagree and view Sorensen as a bad fact case rather than as an undermining of the Wandry mechanism. Regardless, at the time of the preparation of the gift tax return the transfer mechanism will already have been implemented if one had been used. For the gift tax return preparer, the key is reflecting the mechanism used fully and properly on the return. But in light of the uncertainty created by Sorensen (at least according to some advisers) practitioners should suggest the more robust approach to return preparation noted above, namely confirming that the mechanism used was properly implemented and that all appropriate documents were created and properly executed, etc. If the return is being prepared by a CPA and the CPA believes that certain aspects of this type of analysis are within the purview of the client's attorney, the CPA should insist that the attorney be permitted a broad review of the return for this purpose.

Words matter in valuation adjustment clauses. In a notable case, *Nelson*, the taxpayer's valuation adjustment mechanism failed because it did not use the requisite language of referring to "gift tax

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[11] *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.

value as finally determined" and instead had a reference to an appraised value.[12] 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 might communicate this concern with the attorney who drafted the transaction documents and together they should determine a course of corrective action.

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? 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. If an independent incomplete gift trust serves as the spillover that trust should be correctly identified on the return and the trust instrument might also be attached as an Exhibit to endeavor to bolster qualification for having met the adequate disclosure rules.
- If the spillover is to a GRAT the gift tax return should disclose all relevant information as to the GRAT and attach the GRAT trust 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. 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.
- 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

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

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

Many clients may pursue estate planning techniques to divest themselves of all of the equity in closely held businesses to achieve various objectives:

- to use up some or all of their lifetime exemptions,
- to shift value (*e.g.*, by a note sale) out of their estate, or
- to avoid a challenge under *Powell* that the decedent in conjunction with the trustee of the transferee trust control the interests in the entity because not all entity interests were effectively transferred out of the taxpayer's control.

On these occasions, some estate planners may used what has been dubbed a "two-tiered *Wandry*" arrangement in order to avoid a *Wandry* clause resulting in some part of the equity being returned to the transferor. Such a technique could consist of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets) left by the *Wandry* adjustment clause in the taxpayer's hands 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 could 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.

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.[13]

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. If the transfer is to a non-grantor trust other considerations may apply.

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

[13] The Biden Green Book has proposed the severe restriction on discounts and a host of other changes. See . Shenkman, Blattmachr and Matak, "Analysis of the Biden Administration's Fiscal Year 2024 Revenue Proposals," LISI Estate Planning Newsletter #3029 (April 6, 2023) at http://www.leimbergservices.com.

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 had been 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 transaction. Following is an example:

    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 involved, 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. Note also that the client's personal financial statement should properly reflect the nature of the transaction (e.g., indicate a

sale for a fixed dollar amount in a footnote, not a reduction in the percentage interest owned without any clarification of the defined value mechanism.)

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 [list name of the 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. For almost every gift tax return there is an intent to toll the statute of limitations by meeting the adequate disclosure rules. If the 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.[14]

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 that might result from a valuation adjustment of a Petter type defined value mechanism 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. Note that many transactions are structured to have the charity receive a minimum interests in the transaction even if the defined valuation mechanism is not activated. In such instances a $0 charitable gift may still be reported for the contingent gift, but a dollar value gift for the actual gift.

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[15] might be allocated to various transfers, particularly if the valuation adjustment clause is invoked. The following sequence might be an approach that would be reasonable to use for a transaction, although practitioners should evaluate the unique nuances of every plan.

- The first trust that you are certain that the client would want to treat as a full GST exempt trust (i.e., the priority for a zero-inclusion ratio), to which you want to allocate GST exemption, should be elected to be treated as a GST trust. The remaining trusts could have an election made so that they are not treated as GST trusts for purposes of the

[14] Code section 6501(e)(2).
[15] "GST exemption" is a technical term defined by Code § 2631(a).

automatic allocation rules, so that an affirmative 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 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 only about 1% of term life insurance policies are ever collected.[16] 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 the preceding paragraph, 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, for example, that gift might be reported on Schedule A Part 3. However, a note sale to that trust in a later year 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 might be allocated to it.

GST Allocations and ETIPs

[16] https://www.bankrate.com/insurance/life-insurance/term-life-insurance/#what .

When reporting a gift to a grantor retained income trust (GRIT) or other trust includible in the grantor's estate, you generally would not make an allocation of GST exemption. This is because the inclusion ratio is not permitted to be calculated until the estate tax inclusion period (ETIP) closes (e.g., at the end of the trust term). 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). But if the asset has appreciated substantially during the trust term, that would defeat the typical planning goal of leveraging the growth from inception out of the client's estate in a dynastic GST exempt trust.

Special GST Allocation Considerations for 2026

However, with 2026 and the potential reduction of GST exemption by half, it may be worth allocating any GST possible to current and even past transactions if that GST exemption would merely be lost in 2026.

Reporting Planning Completed for Married Taxpayers

Perhaps One (Not Both) Spouse Made Gifts

Clients engaging in pre-2026 transfers are often seeking to secure the bonus exemption before the exemptions are reduced by operation of the sunsetting of the Tax Cuts and Jobs Act. Such clients need to consider that, in order to secure the bonus exemption, the gift transfer may need to be quite substantial. 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 of $5 million and dies after a reduction in the exemption to $5 million inflation adjusted, no benefit from the perspective of securing bonus exemption will be gained from the gift other than the incremental benefit of any growth in the value of the $5 million gift.

Practitioners are likely advising married clients with the capacity to make gifts of $5 million each (for a total gift of $10 million) to have only one spouse make the gift of $10 million. This way, 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. Caution must be taken to evaluate whether there are any step-transaction issues pertaining to the retitling of assets before the one spouse gifts assets. For example, if assets were held jointly by both spouses or in the wife's name, and retitled so the husband could fund the gift to use his exemption, how much time should pass from the retitle to the gift? What other economic events might be advisable to occur during that interim period? In the Smaldino case, the husband purportedly gave the wife interests in a family real estate LLC. She only purportedly held those interests for one day before making a subsequent gift to a trust for husband's children from a prior marriage. Note that in *Smaldino* the wife did not receive a K-1 for the one day of purported ownership and no entity

documents were created reflecting her ownership.[17] The question is how much analysis should the gift tax return preparer undertake to corroborate either the risk or the steps taken to mitigate the step-transaction risk? This is discussed further in the following section.

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, may have had only one spouse made 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, whether or not disclosed on the gift tax return, that might be useful to deflect a step-transaction audit. If the property is community property counsel may have to prepare a transmutation agreement to properly bifurcate the assets and recharacterize it as separates property to support a later gift transfer. 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.[18]

Spousal Lifetime Access Trusts (SLATs)

[17] Smaldino v. Comr., T.C. Memo. 2021-127 (November 10, 2021).
[18] IRC Sect. 2036(a).

SLAT strategies were used throughout 2012 and the 2020-2021 estate planning rushes, 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).

A SLATs plan might be crafted as follows. Each spouse creates a trust for the other spouse, avoiding the state law creditor and tax reciprocal trust doctrines.[19] This occurs by making the trusts sufficiently different so the reciprocal trust doctrines cannot be applied by the IRS or a creditor. The trusts can be created at different times, with different assets and trustees, and with sufficiently 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,[20] 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 that practitioner was not fully 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

The practitioner preparing the gift tax return needs to understand the plan sufficiently to reflect it on the gift tax return in a manner that is both consistent with the documentation and supportive of the planning goals.

- 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. [21]
- 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

[19] Steiner and Shenkman, "Beware of the Reciprocal Trust Doctrine," Trusts & Estates magazine (April 1, 2012).
[20] Within Rev. Rul. 95-58, 1995-2 CB 191 safe harbor.
[21] 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.

return preparer might 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.[22] Additionally, the gift tax return preparer might 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. Further, the gift tax preparer should reference the specific item number of the potential marital gift on Schedule A Part 4, line 6.
- The beneficiaries of each SLAT should be identified in the description of the gift on the gift tax return. This is particularly useful where the beneficiaries vary between the SLATs established by each spouse.

Reporting A "Do-Over" Plan for the Married Client

Some clients were reluctant to plan and remain so now despite the harshness of the Biden Green Book proposals, and the scheduled reduction of the exemption by half in 2026.

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 to incorporate such a mechanism.

In order to allow for such a do-over, some attorneys draft trusts 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.[23]

[22] 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.
[23] 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.".

This unique opportunity in a time of great uncertainty has allowed such clients to consummate a large gift to a "QTIP-able" (eligible for the QTIP election) trust and then evaluate throughout the time period before the extended due date for the gift tax return 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 then available.

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 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.

Reporting A Disclaimer "Undo"

Another approach used in some 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 Sale Transactions

While interest rates have risen significantly, many very wealth clients may consider large transfers to lock in current values, lock in discounts and to complete transfers before any of the Biden Green Book proposals may be enacted.

Substituting Higher-Interest for Lower-Interest Notes

Although interest rates have risen substantially, in prior years when interest rates were low, client transactions were commonly restructured to substitute a new note with lower interest rates. For transactions done in the current higher interest rate environment, this planning will likely again be pursued when interest rates decline at some future date. For example, assume that parent sold

assets to a trust when the required interest rate was 2.64% and the long-term rate later declined to 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 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.

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 engage in these transactions and practitioners would 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."[24] 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 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.

The gift tax return preparer for G2's 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 in a timely manner, 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.

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[24] 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).

Avoid Common Form 709 Errors

Gift tax return preparers should also be wary of some of the more common mistakes/oversights that can put 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?

2. Were there front-loaded gifts to Code Sec. 529 plans that could affect current reporting?

3. 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.

4. 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.

5. 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 are not intuitive. Further, with the growth of the estate tax exemption to $5 million inflation adjusted, and more recently to $10 million inflation adjusted through the end of 2025, 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 is at a temporarily large level now. 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 allow GST exemption to allocate 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.

Adequate Disclosure 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 make 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. Creative planning approaches have created additional and sometimes novel gift tax reporting considerations that practitioners must identify, understand and then determine how to report.

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, consider passing on the work. Familiarize yourself with gift tax guidelines and rules carefully to ensure nothing is overlooked.