Marketplace

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The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Rest in Peace: Adequate Disclosure on Gift Tax Returns – Seeking Closure on Clients' Legacies.

MARKET TREND: The IRS wants full compliance with adequate disclosure safe harbors to trigger the three-year statute of limitations period on its review of reported gifts and non-gift transactions.

SYNOPSIS: Adequate disclosure triggers the running of the three-year statute of limitations for the IRS review of gifts or completed non-gift transfers, like installment sales to grantor trusts. Although clients may have concerns that "over-disclosing" details related to their gifts or non-gift transfers may draw IRS attention to their return, the benefits of adequate disclosure may generally offset these concerns by providing closure on reported gift/transaction values, clarity with regard to the impact of past gifts on future planning, and the knowledge that, if an IRS review occurs within the limitations timeframe, the advisors and family members involved in the gift/transaction will be available to provide information and documentation to support the review (as opposed to years later, when they may no longer be accessible). Adequate disclosure, however, requires significant information, and the IRS may closely review these disclosures and focus on significant gaps.

TAKE AWAY: If clients are going to spend the time and expense to plan, then they should also try to protect their efforts. Adequate disclosure is a proactive tool for

clients to ensure some finality in the valuation and potential taxation of their lifetime legacy planning. Clients should plan to provide full and detailed disclosure, which will require extensive cooperation and coordination among all the client's advisors (insurance, financial, accounting, legal) to avoid mistakes that could otherwise result in costly amendments of returns and additional audit and tax exposure to the client.

MAJOR REFERENCE: IRS Field Service Advice (FSA) 20152201F.

WHAT IS ADEQUATE DISCLOSURE?

Adequate disclosure is a term used under the Treasury Regulations that means a client has met the conditions for disclosure that triggers the running of the 3-year statute of limitations ("**SOL**") for the IRS review of gifts or completed non-gift transfers, like installment sales to grantor trusts (collectively, "**disclosable transfers**"). Generally, the IRS must assess any gift tax on a disclosable transfer within three years of filing the federal gift tax return reporting that transfer,[1] so long as the transfer is disclosed in "a manner adequate to apprise the IRS of the nature of the gift and the basis for the value" reported.

WHY IS ADEQUATE DISCLOSURE IMPORTANT FOR CLIENTS?

Clients may have concerns that "over-disclosing" details related to their disclosable transfers, particularly non-gift transactions, may draw IRS attention to their return. The benefits of providing adequate disclosure will generally outweigh the client's apprehensions, as follows:

- Valuation Closure/Finality. Without adequate disclosure, **the IRS may challenge and assess, or commence proceedings to collect, gift tax on a disclosable transfer at any time,** even at death, and may revalue those assets during review of the estate. This open-ended exposure can leave the client or the client's family with latent and unexpected tax issues.

  Simple Example: In 2015, John gives $5.43 million of marketable assets to a dynasty trust for his descendants, allocating all his available gift and GST tax exemptions. He also sells 100 shares in FamCo (his family business) valued at $15 million in exchange for a 20-year note that has a $15 million face amount and charges annual interest at the appropriate applicable federal rate ("**AFR**"). John reports the gift on a timely-filed federal gift tax return but does not adequately report the sale. John unexpectedly dies in 2020, at which time the IRS reviews the 2015 gift tax return and revalues the FamCo shares sold at $20 million. The IRS assesses gift tax, interest, and

penalties on the additional $5 million gift. Further, the dynasty trust is not fully-GST exempt, which will later subject the trust assets to GST tax.

If the client provides adequate disclosure of the disclosable transfer, however, after the SOL has run, the IRS cannot revalue the transferred assets for later gift or estate tax purposes.

- Predictability for Future Planning. Since the federal tax reporting of gifts and allocations of gift and GST tax exemption is cumulative in nature, errors in prior years will impact the future calculations of the client's available exemptions and the amount of taxable gifts made. If the potential additional tax exposure remains unknown, it will need to be considered in subsequent gifts and transactions. Thus, adequate disclosure and the running of the SOL can provide predictability regarding the amount of gift and GST tax exemption that has been used for prior disclosable transfers and the GST tax exempt status of trusts to which those disclosable transfers have been made, which facilitates future planning.

- Access to Knowledge/Support. Even though adequate disclosure gives notice to the IRS, advisors should be able to provide current input and support if issues or questions arise during the SOL period, unlike later, such as at the client's death, when the potential liability may be even more substantial but the participating advisors, trustees, and/or family members are no longer available, information is forgotten, documents misplaced or lost, etc. This will leave the client's descendants to inherit the problem, which can be costly to resolve.

WHEN TO DISCLOSE?

Adequate disclosure likely will seem standard for gifts that would be required to be filed on a gift tax return (e.g., taxable gifts or those to which gift or generation-skipping transfer ("**GST**") tax exemption will be applied), particularly if the gift is of difficult-to-value assets, is made in trust, or involves a split-interest between the donor, charity, and/or another beneficiary (like a qualified personal residence trust ("**QPRT**"), charitable lead or remainder trusts, etc.).

As shown above, however, adequately disclosing non-gift transactions can be just as important for clients. Examples of some common estate and life insurance non-gift transactions that clients may want to consider disclosing to trigger the SOL include:

- Installment sales to grantor trusts
- Intra-family (AFR) loans
- Sale of a client's existing life insurance policy to the client's grantor trust

- Private split-dollar arrangements (e.g., split dollar loans charging adequate interest or economic benefit arrangements where the trust holding the policy reimburses the grantor for the economic benefit portion of the premium paid)
- "Zeroed-out" split-interest gifts, like grantor retained annuity trusts ("**GRATs**") and charitable lead annuity trusts ("**CLATs**")
- Exercises of nonfiduciary powers of substitution in grantor trusts, where assets of equivalent value are substituted for existing trust assets

ARE THERE ADEQUATE DISCLOSURE "SAFE HARBORS"?

Yes. Disclosable transfers reported on a gift tax return will be considered adequately disclosed if the return provides or attaches information specified under the Treasury Regulations. There are adequate disclosure requirements for (1) gifts,[2] (2) completed non-gifts,[3] and (3) transfers subject to the special valuation rules of Internal Revenue Code ("**Code**") §§ 2701 or 2702 (e.g., GRATs, QPRTs, etc.),[4] although there is overlap among some of these requirements. For example:

For Gifts. There is adequate disclosure if the gift tax return provides all of the following:

1. A description of the transferred property and any consideration received by the transferor.
2. The identity of, and relationship between, the transferor and each transferee.
3. If the property is transferred in trust, the trust's tax identification number and a brief description of the trust terms (or a copy of the trust instrument).
4. Either: (a) a detailed description of the method used to determine the fair market value of property transferred;[5] or (b) the submission of an appraisal of the property that satisfies the specified Treasury Regulation requirements.[6]
5. A statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer.

For Non-Gifts. Adequate disclosure for non-gifts requires the same information required under numbers 1, 2, 3, and 5 above. It also requires, however, an explanation as to why the transfer is not a transfer by gift under the Code (e.g., for an installment sale to a grantor trust, evidence, such as descriptions of valuation or appraisals that show that the fair market value of the property sold equals the fair market value of the note received).

HOW STRICT MUST COMPLIANCE BE FOR ADEQUATE DISCLOSURE?

Assume strict. In recently released FSA 20152201F, the IRS found that the taxpayers had not satisfied the adequate disclosure requirements in relation to gifts of partnership interests where (1) the partnerships were not identified correctly, (2) one digit was left off of each partnership's tax identification number ("**TIN**"), (3) the description said that the land owned by the partnerships was appraised by a certified appraiser, but no appraisal was attached and the appraisal did not value the actual partnership interests, and (4) the description summarily stated that discounts were taken for minority interest, for lack of marketability, etc. to obtain the gift's value.[7] Clearly, there appear to be several lapses in the disclosures provided by the taxpayer above, but the FSA shows that the IRS can closely review these disclosures, and their discovery of minor error may increase their focus.

WHAT ARE SOME GENERAL GUIDELINES FOR ADEQUATE DISCLOSURE?

The recent FSA illustrates a few general rules of thumb for adequate disclosures:

- **More is More**. While disclosure may seem risky to clients, the incentive is to maximize the information provided. For example, for gifts or sales to a trust, provide a copy of the entire trust agreement, not a summary. Similarly, provide full copies of all appraisals and related information. Providing summaries increases the chances of summarizing something incorrectly or leaving out necessary information.
- **Details Matter**. Make sure TINs, names of entities, donors, bank account numbers, etc. are accurate.[8] Do not give the IRS an excuse to challenge disclosures over relatively minor errors.
- **Get it Right the First Time**. The importance of initially filing an accurate gift tax return with full and complete adequate disclosure cannot be overstated. The time, cost, and extended audit and potential tax exposure associated with amending past returns that failed to adequately disclose a prior disclosable transaction can be exponential.
- **Coordination if Crucial.** Ensuring proper adequate disclosure requires coordination and cooperation among <u>all</u> the client's advisors, insurance advisors, financial advisors, accountants, and attorneys. Otherwise, information can be easily missed or misunderstood, elections on gift tax returns may not be properly made, transfer amounts may be incorrectly reported, etc. Advisors should operate as a team, keep an open dialogue regarding client matters, and be responsive to inquiries, particularly around filing deadlines.

TAKE AWAY

If clients are going to spend the time and expense to plan, then they should also try to protect their efforts. Adequate disclosure is a proactive tool for clients to ensure some finality in the valuation and potential taxation of their lifetime legacy planning. Clients should plan to provide full and detailed disclosure, which will require extensive cooperation and coordination among all the client's advisors (insurance, financial, accounting, legal) to avoid mistakes that could otherwise result in costly amendments of returns and additional audit and tax exposure to the client.

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This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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[1] Code § 6501(a).

[2] Treas. Reg. § 301.6501(c)-1(f)(2).

[3] Treas. Reg. §301.6502(c)-1(f)(4). Note that completed transfers to members of the transferor's family that are made in the ordinary course of operating a business are deemed to be adequately disclosed, even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes. For example, in the case of salary paid to a family member employed in a family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns.

[4] Treas. Reg. § 301.6501(c)-1(e).

[5] See Treas. Reg. § 301.6501(c)-1(f)(2)(iv) for the specific and detailed information that must be included in this description.

[6] See Treas. Reg. § 301.6501(c)-1(f)(3) for the specific requirement for an appraisal submitted in lieu of a detailed description of the value of the property transferred.

[7] See discussion in Steve R. Akers, *Estate Planning Current Developments and Hot Topics*, p. 119, October 2015, Bessemer Trust.

[8] Note, however, that if oversights happen, they may not always be fatal. If the return fails to meet all the safe harbor requirements listed above but still provides a substantial disclosure of the gift, the taxpayer may be able argue that the disclosure was sufficient "to apprise the IRS of the nature of the gift and the value so reported" under the general rule and thus triggered the running of the SOL. But it is certainly preferable to be able to rely on the safe harbors under the Treasury Regulations.