Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:3:FTL:POSTF-148048-02
JTLortie

date: OCT 3 1 2002

to: Patricia Darrigan, Estate Tax Attorney

from: JOHN T. LORTIE
Senior Attorney (SBSE)

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ubject: **Advisory Opinion - Estate of** [redacted]

This memorandum responds to your August 21, 2002 request for advice.

Issues

1) Under the new I.R.C. §6501(c)(9), as amended by the Tax Reform Act of 1997 (the 1997 Act), does the statute of limitations commence to run on taxpayer's gifts made in [redacted] and [redacted] that were not disclosed on gift tax returns filed for those years?

2) If gift tax may be assessed under section 6501(c)(9) as amended, with respect to the gifts made in [redacted] and [redacted] that were not reported on a gift tax return, are the omitted gifts taken into account as a "prior taxable gift" under I.R.C. § 2504(c),as amended by the IRS Restructuring Act of 1998 (the 1998 Act)in computing gift tax liability for [redacted]?

Conclusion

1) Section 6501(c)(9), as amended by the 1997 Act, allows assessment, at any time, of gift taxes imposed on gifts required to be disclosed on the return that were not disclosed, or for gifts under §2701(d) which were not disclosed. Accordingly, in this case, the gift tax liabilities for the [redacted] and [redacted] undisclosed gifts may be assessed at any time.

2) The value of the [redacted] and [redacted] gifts that were not disclosed may be taken into account as "prior taxable gifts" in computing the [redacted] gift tax liability pursuant to IRC § 2504(a) and (c).

Facts

During the course of examining the above captioned estate, you came across unreported cash gifts for [redacted], [redacted] and [redacted].

In [redacted], the taxpayer filed a Form 709 and reported taxable gifts of $[redacted]. No gift tax was due or paid because the lifetime taxable gifts were under the unified credit amount. For [redacted], a cash gift in the amount of $[redacted] was omitted. The three year period described in IRC § 6501(a)has elapsed since the filing of the [redacted] return.

In [redacted], the taxpayer filed a Form 709 and reported current taxable gifts of $[redacted]. A gift tax was assessed and paid of $[redacted]. For [redacted], a cash gift in the amount of $[redacted] was omitted. The three year period described in IRC § 6501(a)has elapsed since the filing of the [redacted] return.

In [redacted], the taxpayer filed a Form 709 and reported taxable gifts of $[redacted]. No gift tax was assessed or paid because the gifts in [redacted] were less than the increased unified credit amount from [redacted] to [redacted]. For [redacted], a cash gift in the amount of $[redacted] was omitted. The statute of limitations is still open for [redacted]. The taxpayer died on [redacted].

Analysis

As a general rule, a gift tax is imposed upon the transfer of any property by gift. I.R.C. §2501(a). The donor must file a gift tax return and pay the tax on or before April 15th of the year following the year in which the gift was made. I.R.C. §§ 6019, 6075(b).

Statute of Limitations

Prior to the 1997 and 1998 Acts, the period for assessment of gift tax for a calendar period generally expired three years from the date a gift tax return for that period was filed. The statute of limitation protection extended to all gifts made in the calendar period for which a return was filed, including gifts not reported on the gift tax return. The 1997 Act amended IRC § 6501(c)(9) to provide that the period of assessment will not commence to run for any gift made in calendar years ending after August 5, 1997 (the effective date of the 1997 Act), that is not adequately disclosed on a gift tax return, even if a return is filed for the calendar year reporting another gift made by the donor.

Section 2504: Adjustment of prior taxable gifts for gift tax purposes.

Under the unified estate and gift tax system, a single rate schedule is applied to an individual's cumulative gifts and bequests. Gift tax is computed by determining a tax on the total of the gifts made by the donor in the current calendar year plus the gifts made in prior years ("prior taxable gifts"). The tax computed is then reduced by the tax paid on the prior taxable gifts. The result is the gift tax on the current gifts.

Prior to the 1998 Act, § 2504(c) provided that if the statute of limitations on assessment for a prior gift had expired, but a gift tax had not been paid or assessed with respect to the calendar period in which the gift was made, then, for purposes of determining the total amount of the donor's prior taxable gifts, the value of any gift made in the prior calendar period could be adjusted. On the other hand, if a gift tax had been paid with respect to the prior closed year, the value of the prior gift could not be adjusted. This prohibition applied only to valuation adjustments. The Service could make adjustments to prior taxable gifts with respect to legal issues (e.g., annual exclusion, allowance of marital deductions) at any time.

Under § 2504(c) as amended by the 1998 Act, if the time has expired for assessing gift tax for a preceding calendar period under § 6501(c)(9), then the value of a gift made in the prior calendar period cannot be adjusted (regardless of whether or not a gift tax has been assessed or paid for a prior calendar period). Rather, the value of the gift is the value as "finally determined" for gift tax purposes (defined in § 2001(f)). Section 2504(c) as amended applies only to gifts made after August 5, 1997. Under Treas. Reg. §25.2504-2(b) this prohibition applies to both valuation and legal issues.

Section 2001(f): Adjustment of prior "adjusted taxable gifts" for estate tax purposes.

The estate tax is computed by determining a tax on the value of the decedent's taxable estate plus the value of lifetime gifts ("adjusted taxable gifts") made by the decedent. The tax computed is then reduced by the gift tax paid on the adjusted taxable gifts. The result is the estate tax on the taxable estate.

Prior to the enactment of the 1997 and 1998 Acts, there was no estate tax provision corresponding to § 2504(c). Therefore, even where the period of assessment expired for a prior gift on which a gift tax was paid or assessed, the amount of any gifts

made in that period could be adjusted for purposes of determining adjusted taxable gifts in computing the estate tax liability. See Evanson v. United States, 30 F.3d 960, 963 (8th Cir. 1994); Levin v. Commissioner, 986 F.2d 91, 92 (4th Cir. 1993); Estate of O'Neal v. United States, 99-2 USTC ¶36,365 (ND Ala. 1999), aff'd, 2001-2 USTC ¶ 60,412 (11th Cir. 2001).

Under § 2001(f) as amended by the 1997 Act, if the time has expired for assessing gift tax for a preceding calendar period under § 6501(c)(9), then the value of the gift, for purposes of computing the estate tax liability, is the value of the gift as "finally determined" for gift tax purposes (as defined in § 2001(f)).

Discussion

As noted above, the 1997 Act provides that the amendments to § 6501(c)(9) (commencing the running of the period of limitations only if the gift is adequately disclosed) apply to gifts made in calendar years ending after August 5, 1997 (that is, all gifts made in calendar year 1997 and thereafter). On the other hand, § 2504(c), as amended, applies only to gifts made after August 5, 1997.

As stated in the Preamble to the final regulations (Preamble to T.D. 8845, 64 FR 67769, 1999-2 C.B. 683,686), § 25.2504-2(c), Example 2, illustrates the interaction between § 2504(c) and § 6501(c)(9) with respect to gifts made between January 1, 1997, and August 6, 1997, since § 2504(c) as amended applies only to gifts made after August 5, 1997, but § 6501(c)(9) as amended applies to all gifts made in 1997. The example involves a situation where a gift is made in 1997 prior to August 6, 1997, that is not adequately disclosed on the return filed for 1997. The example concludes that the period for assessment with respect to the pre-August 6, 1997, gift does not commence to run because the gift was not adequately disclosed. Thus, a gift tax may be assessed with respect to that transfer. Further, notwithstanding the effective date of section 2504(c),because the statute of limitations with respect to the transfer is still open, the gift may be taken into account as a prior taxable gift in computing gift tax liability for subsequent years. Also, adjusted taxable gifts may be adjusted under § 2001(f) in determining estate tax liability.

The example illustrates that, because the statute of limitations does not begin to run on gifts made between January 1, 1997 and August 6, 1997, if those gifts are not adequately disclosed, the treatment for those gifts will be the same (under § 2504(c)), as for gifts made after August 5, 1997, that are not adequately disclosed.

Specifically, in Example 2, A transferred stock to A's child in 1996. A filed a gift tax return and properly reported the 1996 transfer and paid the gift tax on the transfer. Next, on August 1, 1997, A transferred additional stock to A's child, in exchange for a promissory note. On September 10, 1997, A transferred stock to A's other child. On April 15, 1998, A timely filed a gift tax return for 1997 and reported (and adequately disclosed) the September 10th transfer but not the August 1st transfer. In 2002, A transfers additional property to A's child, and timely files a gift tax return reporting and adequately disclosing the gift.

The example concludes that under IRC section 2504(c), in computing A's prior taxable gifts for purposes of determining A's gift tax liability for 2002, the 1996 gift cannot be adjusted because the transfer occurred before August 6, 1997, and a timely gift tax return was filed on which a gift tax was assessed and paid.

However, with respect to the August 1, 1997 transfer, the example states that A's "prior taxable gifts" can be adjusted to reflect the August 1, 1997 transfer because, under Treas. Reg. 301.6501(c)-1(f), the statute of limitations for assessing gift tax on the transfer did not commence to run because that gift was not adequately disclosed on the 1997 gift tax return. Accordingly,, "a gift tax may be assessed with respect to the August 1, 1997 transfer and the amount of the gift would be reflected in prior taxable gifts for purposes of computing A's gift tax liability for 2002."

In the instant case, the adequate disclosure rules contained in §6501(c)(9), as amended by the 1997 Act, apply to the cash gifts made in [redacted] and [redacted]. Because these gifts were omitted on the [redacted] and [redacted] gift tax returns, the gifts were not adequately disclosed and the statute of limitations has not begun to run. Accordingly, gift tax may be assessed on those gifts. Further, as is illustrated in § 25.2504-2(c), Example 2, under § 2504(c), the value of those gifts will be taken into account in determining prior taxable gifts for purposes of computing the [redacted] gift tax liability. In addition, under § 2001(f), these gifts will be included in determining adjusted taxable gifts for purposes of determining the estate tax liability.

We note that under § 25.2504-2(d), the regulations implementing § 2504(c) as amended by the 1997 Act (including § 25.2504-2(c), Example 2) are effective for transfers of property by gift made after August 5, 1997, if the gift tax return is filed after December 3, 1999. Similarly, the regulations promulgated under § 6501(c)(9) as amended by the 1997 Act, are effective for gifts made after December 31, 1996, for which the gift tax return for the calendar year is filed after December 3, 1999. See Treas. Reg. § 301.6501(c)(1)(f)(8).

Under § 7805(b)(1), Treasury and the IRS are generally precluded from promulgating retroactive regulations. Accordingly, in this case, under § 25.2504-2(d), the regulations are generally effective only for those gifts where the gift tax return reporting the transfer is filed after December 3, 1999, the date the final regulations were published in the federal register. Nonetheless, § 25.2504-2(c), Example 2, follows the literal language of the statute and therefore, the result with respect to transactions that occur after the effective date of the statute and prior to the effective date of the regulations, should be the same as that described in the example.

Specifically, § 2504(a) provides the general rule that in computing prior taxable gifts for purposes of determining the current gift tax liability, "there shall be treated as gifts such transfers as were considered gifts under the gift tax laws applicable to the calendar period." However, under § 2504(c),as amended, the IRS is precluded from making adjustments to prior taxable gifts "if the time has expired under § 6501 within which a tax may be assessed under chapter 12" on the prior gifts. However, if the statute of limitations has not expired, the IRS is not precluded from making any adjustments. S. Rep. No. 174, 105th Cong. 2nd Sess. (April 2,1998). Since, under § 6501(c)(9), the gifts were not reported on the returns and thus, not adequately disclosed on the returns, the statute of limitations with respect to those gifts has not expired. Accordingly, the [redacted] and [redacted] gifts can be taken into account in determining prior taxable gifts under § 2504(c).

Thus, § 25.2504-2(c), Example 2, merely illustrates the operation of the statutory language. Although the example, technically, is not effective with respect to the transfers at issue in this case, the example follows the literal language of the statute and therefore, the rationale and result in the example, should apply with equal force to this case.

In summary, we recommend that the IRS assess gift tax with respect to the [redacted] and [redacted] cash gifts that were not reported on the [redacted] and [redacted] returns. In addition, we recommend that the IRS make the requisite adjustments to prior taxable gifts in computing the gift tax liability for the subsequent tax year [redacted]. Finally, we recommend that, in determining the estate tax liability, the IRS make adjustments to "adjusted taxable gifts" to reflect the [redacted] and [redacted] cash gifts that were not reported on the returns.

Six-Year Statute of Limitations

Because the interplay between IRC 2504(c) and IRC 6501(c)(9) have not yet been tested by the courts, you may also wish to rely upon I.R.C. §6501(e)(2) for assessing a gift tax on undisclosed gifts made during prior closed years. The section states that "[i]n the case of a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the period for which the return was filed items includible in such gross estate or such total gifts...as exceed...25% of the gross estate stated in the return or the total amount of gifts stated in the return, the tax may be assessed...at any time within 6 years after the return was filed."

Here, however, based on the most recent information you have provided us, it is evident that I.R.C. §6501(e)(2) is not available for use in the [redacted] or [redacted] years due to a failure to exceed the more than 25% omission requirement of that statute. Therefore, we do not recommend that you rely on § 6501(e)(2) for making the [redacted] and [redacted] tax year assessments.

Nonetheless, there was no disclosure of the gifts made on the gift tax returns filed in this case for the [redacted] and [redacted] tax years. Accordingly, as stated above, you are not prohibited from assessing the [redacted] and [redacted] gift tax liabilities. You may also include these gifts for purposes of calculating the correct gift tax liability for the [redacted] tax year.

We hope that this has been of assistance to you in this case. If you have any questions, please call John T. Lortie of our office at (954) 423-7944. We are now closing our file.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

(signed) John T. Lortie
JOHN T. LORTIE
Senior Attorney (SBSE)

NOTED:

(Signed) Kenneth A. Hochman
KENNETH A. HOCHMAN
Associate Area Counsel (SBSE)