Planning for an Unlimited Revaluation Period on Prior Gifts

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Introduction

Taxpayers and their advisers commonly assume that the statutory three-year limit of Section 6501(a) protects them from later revaluation of gifts by the Internal Revenue Service. Such an assumption, however, has been challenged and repudiated in several court decisions, most recently *Evanson*,[1] *Prince*,[2] *Stalcup*,[3] and *Smith*.[4] In these decisions, the Service was allowed to revaluate gifts for estate tax purposes even though the statutory limitation period on the gifts had expired two to 11 years earlier. Revaluation of prior gifts, therefore, appears to be permitted at any time, irrespective of the general three-year statutory limitation period, provided that the value of the gifts affects the computation of current gift or estate taxes. Absent

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[1] *Carroll Evanson*, 94-2 USTC ¶ 60,174 (CA-8), *rem'g* unreported decision (DC-N.D., 1993).

[2] *Estate of Myrtle S. Levin Prince*, 93-1 USTC ¶ 60,128, 986 F2d 91 (CA-4), *aff'g* CCH Dec. 47,337(M), 61 TCM ¶ 2594.

[3] *Twylah Stalcup*, 91-2 USTC ¶ 60,086, 792 FSupp 714 (WD-Okla.).

[4] *Estate of Frederick R. Smith*, CCH Dec. 46,648, 94 TC 872 (1990), *Acq.* 1990-2 CB 1.

proper planning, unwary taxpayers and their advisers may discover that the marginal tax rate at which later gift or estate taxes are computed is substantially higher than otherwise presumed.

This article examines the circumstances under which revaluation of a gift is permitted and explains how such revaluation can affect the computation of current estate and gift taxes. Before so doing, however, it first provides a brief overview of the estate and gift tax computations to highlight the tax benefits associated with inter vivos giving. After presenting this overview, the article explains the statutory limitation period for the assessment of estate and gift taxes and describes the circumstances under which revaluation problems may arise. It then concludes with a discussion of various tax planning strategies that may be used by taxpayers and their advisers to mitigate these problems.

Calculation of Estate and Gift Taxes

The estate and gift taxes are integrated under Chapters 11 and 12 of the Code, in the sense that a single rate schedule applies for both taxes, and the amounts of any post-1976 taxable gifts are included in the gross estate. Both inter vivos and postmortem transfers, therefore, are subject to a cumulative tax calculation. For the gift tax, this cumulative calculation involves three steps. First, the value of any taxable gifts made in the current year is added to the value of all other taxable gifts made after 1976. Taxable gifts, for purposes of this calculation, are defined in Section 2503(a) as those which exceed the annual $10,000 gift exclusion per donee ($20,000 with spousal consent) and do not qualify for either a charitable or spousal deduction under Sections 2522 and 2523. Second, the gross tax is computed on the sum of the current and prior years' taxable gifts using the unified transfer tax rate schedule of Section 2001(c). Third, the gross tax is reduced by the amount of gift tax calculated on the prior years' taxable gifts and any applicable unified transfer tax credit.[5] The effect of this three-step calculation, therefore, is to cause the tax on the current and prior years' gifts to be computed at the current unified tax rates, irrespective of the rates in effect when the prior years' gifts were actually made.

Although the estate tax calculation is different from that of the gift tax, it still involves a three-step cumulative computation. First, the value of the taxable estate is added to the value of the donor/decedent's lifetime adjusted taxable gifts made in post-1976 years and not included in the gross estate under the three-year inclusion rule of Section 2035.[6] Second, the tentative estate tax is computed by applying the unified transfer tax rates of Section 2001(c) to the sum of the taxable estate and lifetime adjusted taxable gifts. Third, the tentative estate tax is reduced by any gift taxes payable at current rates for taxable gifts made after 1976, the total unified transfer tax credit,[7] and any other allowable credits.[8]

Tax Advantages of Inter Vivos Giving

Because of the integrative and cumulative nature of the estate and gift taxes, any taxable inter vivos gift made after 1976 boosts the donor/decedent's taxable estate into a higher tax bracket. Inter vivos giving, nonetheless, continues to provide several tax advantages. Among the most obvious is that the annual gift exclusion and unified transfer tax credit allow assets and their appreciation to be removed from an estate free of tax. Lifetime transfers up to the amounts of the exclusion and credit consequently have the effect of reducing an estate by an amount greater than the face amount of the transfer. In addition, inter vivos giving also allows the value of the estate to be reduced by the amount of the gift tax. As such, payment of a gift tax is often less expensive than an estate tax.

In return for these tax advantages, inter vivos giving has two primary disadvantages. First, the basis of the gifted property carries over to the beneficiary and is not eligible for a step-up valuation at the time of the donor/decedent's death. Second, the donor/decedent, by reducing the value of the estate, also reduces his/her wealth. Psychologically, this reduction may cause concern about future security and comfort.

Illustration. To illustrate the tax advantages of inter vivos giving, consider a donor/decedent who

[5] For purposes of the gift tax calculation, the unified transfer tax credit is defined in Section 2505. This credit is integrated with the unified transfer tax credit available for estate tax purposes under Section 2010. A donor/decedent's estate consequently benefits from the credit only to the extent that it was not previously used to offset any gift tax.

[6] Under Section 2035, the gross estate includes gifts of interests made within three years of death and described in either Section 2036 (retained life estates), 2037 (taking effect at death), 2038 (revocable transfers), or 2042 (life insurance policies). Section 2035 also requires inclusion of any gift taxes paid within three years of death.

[7] The unified transfer tax credit applicable to the estate tax calculation is defined in Section 2010. This credit is integrated with the unified transfer tax credit available for gift tax purposes under Section 2505. See note 5, supra.

[8] Other allowable credits against the estate tax include those under Sections 2011 (state death taxes), 2013 (prior transfers), 2014 (foreign death taxes), and 2015 (death taxes on remainders).

gives two assets valued at $200,000 and $500,000 to his daughter in 1994 and 1995, respectively. In the year 2001, the donor/decedent dies with a taxable estate valued at $2 million. The gift tax paid by the donor/decedent on the 1995 transfer would be $29,600, calculated as shown below.

Value of gift in 1995		$ 500,000
Less: Annual exclusion		(10,000)
Taxable gift in 1995		$ 490,000
Plus: 1994 taxable gift:		
Value of gift in 1994	$200,000	
Less: Annual exclusion	(10,000)	190,000
Total taxable gifts		$ 680,000
Tentative tax on total taxable gifts ($155,800 + 37% over $500,000)		$ 222,400
Less: Gift tax calculated on 1994 gift ($38,800 + 32% over $150,000)		(51,600)
Tentative tax on 1995 gift		$ 170,800
Less: Remaining unified transfer tax credit:		
Total credit available	$192,800	
Less: Credit used in 1994	(51,600)	(141,200)
Gift tax due on 1995 gift		$ 29,600

In addition, the estate tax paid by the donor/decedent's estate in the year 2001 would be $898,800, calculated as shown below.

Taxable estate		$2,000,000
Plus: Adjusted taxable gifts made in post-1976 years		680,000
Total taxable transfers		$2,680,000
Tentative tax on total taxable transfers ($1,025,800 + 53% over $2,500,000)		$1,121,200
Less: Allowable credits:		
Gift taxes on post-1976 taxable gifts	$29,600	
Unified transfer tax credit	192,800	(222,400)
Estate tax		$ 898,800

When the $898,800 of estate tax is discounted back to its 1995 present value using a 6 percent annual interest rate, it becomes equivalent to $633,619 of estate tax in 1995.[9] Adding this present value amount to the $29,600 of gift tax paid in 1995, the total present value of the estate and gift taxes paid by the donor/decedent in this example is $663,219 ($633,619 + $29,600). This total compares to a 1995 present value of $779,918 of estate tax which would have been payable had the donor/decedent held the assets until the time of his death in 2001.

Alternative Assumption. To more completely understand the calculation of the $779,918 comparative estate tax, consider an alternative assumption under which the donor/decedent does not make either of the inter vivos gifts, but instead retains the two assets in his/her estate until death. Under this assumption, if the two assets, valued at $200,000 and $500,000, appreciate at the rate of six percent per year, they would be worth $300,726 and $709,260, respectively, in the year 2001.[10] The estate tax payable on the donor/decedent's estate in 2001 would be $1,103,492, computed as shown below.

[9] The 1995 value of the estate tax is calculated using the present value formula of $p = 1/(1 + i)^n$, where p denotes the present value of the estate tax in 1995, i denotes the annual interest rate (i.e., 6%), and n denotes the number of discount periods (i.e., six years from 1995 to 2001).

[10] The values of the two assets in the year 2001 are calculated using the future value formula of $f = (1 + i)^n$, where f denotes the future value of an asset in 2001, i denotes the annual appreciation rate (i.e., 6%), and n denotes the number of discount periods (i.e., seven years from 1994 to 2001 in the case of the $200,000 asset and six years from 1995 to 2001 in the case of the $500,000 asset).

Taxable estate:	
Asset valued at $200,000 in 1994	$ 300,726
Asset valued at $500,000 in 1995	709,260
Other assets in estate	2,000,000
Total taxable estate	$3,009,986
Tentative tax on total taxable estate ($1,290,800 + 55% over $3,000,000)	$1,296,292
Less: Allowable credit:	
Unified transfer tax credit	(192,800)
Estate tax	$1,103,492

When the $1,103,492 of estate tax payable in the year 2001 is discounted back to its present value in 1995 using a six percent annual interest rate, it becomes $777,918.[11] The donor/decedent of this example consequently saves $114,699 of tax ($777,918 – $663,219) simply by making inter vivos gifts of the two assets. This tax savings, despite the assumption of equal discount and appreciation rates, is relatively large. Astute tax advisers, therefore, can readily recognize that even greater tax savings could be achieved when the appreciation rate of the gifted assets exceeds that of the discount rate.

Statutory Limitation Period

In addition to the previously illustrated tax advantages of inter vivos giving, lifetime transfers are commonly assumed to provide an additional benefit in that reconsideration of a gift's value by the Service is thought to be barred after expiration of the general three-year statutory limitation periods of Sections 6501(a) and 6511(a).[12] Taxpayers and their advisers often mistakenly presume, therefore, that problems of valuation will be resolved within a reasonable period of time after the date of a gift, while the parties involved in the valuation are still alive and knowledgeable about the transfer. These presumptions, however, do not fully reflect the provisions of Section 2504(c). As provided by this section, the value of a gift becomes final and is no longer subject to reconsideration by the Service for purposes of subsequent gift tax determinations only when the following three conditions are met:

1. a gift was made in a preceding calendar period;
2. a gift tax was assessed or paid for that taxable period; and
3. the time for further assessment of tax for that taxable period has expired.

When these conditions are met, the value of a gift is the last value that was used and accepted as the basis for an assessment or payment of gift tax before the expiration of the statutory limitation period on the gift. A gift's value consequently may be adjusted by the Service at any time prior to the expiration of this period. In addition, the Service may revalue a gift at a time beyond the close of the statutory limitation period if no assessment or payment of a gift tax occurred because the reported value of the transfer did not exceed the sum of the $10,000 annual gift exclusion and the $600,000 unified transfer tax credit equivalent.[13]

It is important to note that the statutory language of Section 2504(c) addresses only valuation issues and not the propriety of exclusions or deductions that may have been claimed with respect to a gift. Likewise, the language applies only to subsequent gift tax determinations and does not expressly extend to determinations of estate taxes. For these reasons, effective tax planning requires an understanding of the applicability of Section 2504(c) to both estate and gift tax issues.

Applicability to Gift Taxation

Rev. Rul. 79-398. Two fundamental revenue rulings which illustrate the applicability of Section 2504(c) to issues of gift taxation are Rev. Ruls. 79-398 [14] and 84-11.[15] In Rev. Rul. 79-398, an unmarried donor transferred $100,000 to an adult child on the condition that the child pay the resulting federal gift tax. The transfer was the first gift

[11] The 1995 value of the estate tax is calculated in the same manner as explained in note 9, supra).

[12] Pursuant to Section 6501(c) and (e)(2), a three-year statutory limitation period on revaluation of prior year gifts is not applicable where a donor files a false return, willfully attempts to evade tax, fails to file a return, agrees to extend the statutory limitation period, substantially omits reporting a gift, or engages in certain other acts.

[13] The amount of the unified transfer tax credit authorized by Section 2505 is $192,800. This credit offsets the tax on $600,000 of taxable transfers.

[14] Rev. Rul. 79-398, 1979-2 CB 338.

[15] Rev. Rul. 84-11, 1984-1 CB 201.

made by the donor in excess of the annual gift exclusion and would not have resulted in a gift tax liability because of the unified transfer tax credit. The donor, nonetheless, did not want to reduce the tax by the credit, but instead wished the donee child to pay it. The issue was whether the language of Section 2505 made the unified transfer tax credit mandatory, or whether it allowed the donor to use the credit on a discretionary basis. The Service held that Section 2505's use of the phrase "shall be allowed" in conjunction with the word "allowable" mandated that the credit be utilized.

Rev. Rul. 84-11. Relying in part on Rev. Rul. 79-398, Rev. Rul. 84-11 addressed whether a donor's use of the unified transfer tax credit of Section 2505 resulted in an assessment or payment of a gift tax that would preclude subsequent adjustment to a gift's value under Section 2504(c). In this ruling, a donor made a gift of closely-held stock valued on the gift tax return at $123,000. Because the amount of the gift tax liability on the transfer was fully offset by the unified transfer tax credit, no tax was paid at the time. Four years later, the donor made another gift valued at $230,000. Upon audit of the gift tax return for the second transfer, an adjustment was made by the Service to increase the value of the earlier gifted stock to its actual value at the time of the transfer. No gift tax was assessed as a result of this revaluation, however, because the statutory limitation period on the gifted stock had expired. Instead, the Service adjusted the aggregate sum of the donor's taxable gifts for purposes of computing the gift tax on the second transfer. The donor protested the adjustment on the grounds that the use of the unified transfer tax credit constituted an assessment or payment of gift tax and, as such, the revaluation was barred by Section 2504(c).

In its analysis of the ruling, the Service first pointed out that Rev. Rul. 79-398 had earlier held that the unified transfer tax credit was mandatory and must be applied to the extent allowable. It then looked at the House and Senate explanations of Section 2504(c) and noted that neither intended the section to prevent later revaluation of a gift when no tax had been paid with the return. Finally, it considered the applicability of Sections 6201, 6202, and 6203, which authorize tax assessments, and determined that taxes which were offset in their entirety by a credit were not "assessed or paid" within the meaning of Section 2504(c). The Service consequently held that the use of the unified transfer tax credit did not result in an assessment or payment of gift tax and so later adjustment of a gift's value after expiration of the statutory limitation period was permissible for purposes of determining a current gift tax.

Applicability to Estate Taxation

As expounded by the previous revenue rulings, revaluation of a gift after expiration of the statutory limitation period is allowed for current gift tax purposes whenever the reported value of the gift in the closed period did not result in a tax assessment or payment because of the annual gift exclusion or the unified transfer tax credit. Application of this rule to the determination of a current estate tax would appear to produce the same result—that a gift could be revalued for estate tax purposes at any time, irrespective of whether the statute of limitations on the gift had run, provided that no tax had been assessed or paid for the gift. If a gift tax had been paid, Sections 2504(c) and 6501(a) would seem to limit the general period of revaluation to three years.[16]

Boatmen's First National Bank. The earliest case dealing directly with the issue of whether a gift could be revalued for estate tax purposes after expiration of the statutory limitation period on the gift was *Boatmen's First National Bank of Kansas City.*[17] In this case, the decedent's wife made gifts of closely-held corporate stock with a reported value of $802,500 to her children in two different tax years. The decedent elected, on timely filed gift tax returns, to gift-split both stock transfers with his wife.[18] He consequently reported his half-share of the gifted stock's total valuation on the returns and paid an appropriate amount of gift tax. No questions were raised by the Service regarding the reported gift valuation during the statutory limitation period of the gift tax returns.

On the decedent's estate tax return, his half-share of the stock's total gift valuation, $401,250, was reported as his lifetime adjusted taxable gifts. When this return was audited by the Service, however, the valuation was increased to $1,097,105 and additional estate tax was assessed. No additional gift tax was assessed because the statute of limitations on the gifted stock had expired, and under Section 2504(c) the Service was precluded from making

[16] See note 12, supra.

[17] *Boatmen's First National Bank of Kansas City*, 89-1 USTC ¶ 13,795, 705 FSupp 1407 (WD-Mo., 1988). Prior to *Boatmen's*, the Service addressed the applicability of Section 2504(c) to estate taxation in LTR 8447005, July 26, 1984. In this ruling, the Service determined that because Congress did not intend Section 2504(c) to apply to the estate tax, it was not prohibited from revaluing gifts for estate tax purposes, even after expiration of the gift tax statutory limitation period.

[18] An election to gift-split with a married donor is provided for under Section 2513.

such an assessment. The Service contended that the estate tax assessment was permissible, nonetheless, because the strict language of Section 2504(c) applied solely to gift taxation. The personal representative of the estate challenged the Service's position, arguing that the unified nature of the estate and gift taxes required, as a practical matter, the application of Section 2504(c) to estate taxation.

The District Court held for the personal representative of the estate. The court reached this decision by determining that the adoption of a unified system of estate and gift taxation in 1976 indicated a congressional intent for both taxes to operate jointly. To interpret the language of Section 2504(c) strictly, as suggested by the Service, would be contrary to this intent and the unified nature of the two taxes. Moreover, it would present several practical problems in that the statutory limitation period on gift valuations would be constrained only by how long a donor survived after making a gift. The court consequently concluded that, because a finding for the Service would create both uncertainty among donors in planning for their estates and place an undue burden of proof on heirs, personal representatives, and executors to support the value of gifted property, it could not have been intended by Congress.

Smith. Despite the intuitive logic behind the District Court decision in *Boatmen's*, no subsequent courts have chosen to follow it. Instead, they have relied primarily on the reasoning of the Tax Court majority in *Smith*. In this case, the donor/decedent made gifts of closely-held corporate stock two years before his death. The value of the gifted stock was reported as $284,871 on timely filed gift tax returns and gift taxes were paid with the returns. The same value was reported on the donor/decedent's estate tax return as his lifetime adjusted taxable gifts.

After expiration of the statute of limitations on the gifts, but before that on the estate tax, the Service audited the estate tax return and increased the value of the gifted stock to $668,495. The personal representatives of the estate did not dispute the correctness of the Service's valuation. They did contest, however, the authority of the Service to make such a revaluation after the close of the statutory limitation period on the gifts.

In holding for the Service, the majority of the Tax Court determined that Section 2504(c)'s prohibition against subsequent gift revaluations was intended by Congress to apply solely to gift taxes, not estate taxes. The majority reached this determination by examining both the statutory language and legislative history of the section. With respect to the statutory language, the section's use of the phrase "for purposes of computing the tax under this chapter" was interpreted as placing a limit on the revaluation of prior gifts only when the revaluation affected subsequent gift taxes under Chapter 12. Similarly, the legislative history was found to support this strict interpretation because the section, which originally had been enacted in 1954, had not been extended to include the estate tax when Congress unified the estate and gift tax rates in 1976.[19] Lacking such an extension, the majority consequently concluded that Congress must not have intended Section 2504(c) to apply to estate tax matters. The practical problems noted by the District Court in *Boatmen's*, therefore, were determined to require legislative correction, not judicial relief.

A secondary issue addressed by the majority in *Smith* concerned whether the calculation of the gift taxes payable for estate tax purposes under Section 2001(b)(2) should be concomitantly increased to reflect the Service's increase in the value of the donor/decedent's gifted stock. In reaching a decision allowing for such an increase, the majority noted that to hold otherwise would permit the Service to collect barred gift taxes through the imposition of a higher estate tax. The Service acquiesced to this secondary issue shortly after its release.[20]

Eight Tax Court judges dissented to the majority's holding in *Smith*. The primary reason for their dissent was a perceived failure by the majority to examine the purpose of Section 2001(b). Upon such an examination, the dissent concluded that Congress intended Section 2001(b) to operate solely as a computational provision with respect to the unified estate and gift tax rates. Substantive issues, such as valuation, were intended to be defined by reference to other provisions of the Code. The dissent supported this conclusion by noting that the language of Section 2001(b) contains both specific gift tax terminology and an express reference to Section 2503 of the gift tax for a determination of the "total amount of taxable gifts . . . made by the decedent . . ." Based on this language, the dissent consequently determined that Section 2001(b) implicitly incorporated Chapter 12 and its prohibition against gift revaluations into the estate tax computation.

[19] The Tax Reform Act of 1976, P.L. 94-455, 94th Cong., 2nd Sess., H. Rep. 94-1380, 1976-3 CB 744; S. Rep. 94-1236 (Conf.), 1976-3 CB 957.

[20] *Estate of Frederick R. Smith, Acq.* 1990-2 CB 1, footnote 13.

Recent Court Interpretations

Evanson, Stalcup, and Lenheim. Subsequent to the decision in *Smith*, five other courts have examined the issue of gift revaluation after expiration of the statutory limitation period.[21] In general, these courts have followed the logic expressed by the majority in *Smith*. The use of this logic, however, was not necessary in *Evanson*, *Stalcup*, and *Lenheim*[22] since the value of the gifts reported on the original gift tax returns did not result in an assessment or payment of gift taxes. In these cases, the donors/decedents made gifts of mineral rights, land, and/or closely-held corporate stock to family members several years before their deaths. No gift taxes were paid for the gifts, however, because the reported gift valuations did not fully exhaust the amount of the donors/decedents' unified transfer tax credits. After the deaths of the donors/decedents, the Service audited the estate tax returns and determined that the reported gift valuations had been substantially understated. Notices of estate tax deficiencies consequently were sent to the personal representatives and executors of the estates based on the Service's revaluations of the gifts for purposes of the estate tax calculations. These proposed deficiencies were contested by the personal representatives and executors on the grounds that the reconsideration of the gift valuations was barred by expiration of their statutory limitation period. The courts, in reaching decisions for the Service, dismissed these arguments and adopted the strict interpretation of Section 2504(c) expounded by the Tax Court majority in *Smith*.

Robinson. Two other recent cases, *Robinson*[23] and *Prince*, also have addressed the applicability of Section 2504(c) to estate taxation. In *Robinson*, the Service's proposed estate tax deficiency resulted from a dispute over the correct number of annual gift exclusions to which the donor/decedent was entitled. The co-executors of the decedent's estate argued that when the donor/decedent conveyed deeds of real property to her children and grandchildren three to four years before her death, she intended to make gifts to 25 individuals, 16 of whom were minor age great-grandchildren. Only nine individuals, however, were named on the deeds of the property. The remaining gifts to the great-grandchildren were effected by an oral understanding between the donor/decedent and her grandchildren. No gift taxes were paid on the transfers during their statutory limitation period because the reported value of the gifted property did not exceed $250,000 (the sum of 25 annual $10,000 gift exclusions).

Although the Service did not question the number of annual gift exclusions claimed by the donor/decedent during the statutory limitation period of the gifts, it did dispute the number when it audited the estate tax return. Among its proposed adjustments to the estate tax return, therefore, were a reduction in the number of exclusions to nine and a corresponding increase in the amount of estate tax. The co-executors of the estate contested the increased tax, arguing that the oral understanding between the donor/decedent and her grandchildren had created implied trusts for the great-grandchildren. As an alternative argument, the co-executors contended that even if implied trusts had not been created for the great-grandchildren, Section 2504(c) nonetheless barred the Service from increasing the amount of the donor/decedent's lifetime adjusted taxable gifts reported on the estate tax return.

The Tax Court held for the Service. In reaching its decision, the court first determined that since none of the children or grandchildren dealt with the property subsequent to its transfer in a manner indicative of beneficial ownership by the great-grandchildren, no implied trusts had been created. The donor/decedent, accordingly, was entitled to only nine annual gift exclusions. The court then determined that Section 2404(c) did not prevent the Service from recomputing the estate tax based on nine annual gift exclusions because the section applied only to issues of valuation, not exclusion. Finally, the court concluded that even if Section 2504(c) were applicable to issues of exclusion, it would not have prevented the Service's adjustment since, under the strict interpretation established in *Smith*, it did not extend to determinations of estate tax.

Prince. In *Prince*, the donor/decedent began a gift-giving program six years before her death. One year before her death, as part of this program, she transferred several municipal project notes and other property. At the time of these transfers, the only authority existing with respect to the gift tax consequences of the project notes was a Seventh Circuit decision indicating that they were not subject to gift tax. Accordingly, the project notes were only footnoted on the gift tax return and their value was not included in the total value of the year's gifted property. Even if their value had been in-

[21] The Service also addressed the issue of gift revaluation after expiration of the statutory limitation period in TAM 9250004, August 24, 1992. In general, the facts, as well as the holding of the Service in this memorandum, follow *Evanson*, *Stalcup*, and *Lenheim*.

[22] *Estate of Ralph E. Lenheim*, CCH Dec. 46,770(M), 60 TCM ¶ 356.

[23] *Estate of Inez T. Robinson*, 101 TC 499 (1993).

cluded in the total, however, no gift tax liability would have resulted because any applicable tax would have been offset by the annual gift exclusion and partial use of the unified transfer tax credit. The only consequence of including the value of the project notes in the total would have been to reduce the amount of the unified transfer tax credit available for future use.

After the donor/decedent's death, the executor of her estate filed an estate tax return on which the value of the project notes was excluded from the amount of her reported lifetime adjusted taxable gifts. The Seventh Circuit decision previously relied upon in excluding the value of the notes from the estate and gift tax returns, however, was overturned two years later by the Supreme Court, when only one month remained before the statute of limitations on the gifted notes expired. Despite this decision, no amended estate or gift tax returns were filed and the statute of limitations on the project notes lapsed without corrective action by either the executor or the Service.

Subsequent to the lapse of the statutory limitation period on the project notes, but while the statutory limitation period on the estate tax was still open, the Service audited the donor/decedent's estate tax return and issued a notice of deficiency based on a determination that the value of the project notes should have been included in the donor/decedent's lifetime adjusted taxable gifts. This notice was challenged by the executor of the estate on the grounds that the gifted notes were not "adjusted taxable gifts" within the meaning of Section 2001(b) because their statutory limitation period under Section 2504(c) had expired. Neither the Tax Court nor Fourth Circuit found merit in the executor's argument, however. Instead, they determined that since no gift tax had ever been assessed or paid on the project notes, Section 2504(c) could not shield the notes from revaluation by the Service.

Tax Effect of Gift Revaluations

As mentioned earlier, when revaluation of an inter vivos gift occurs, both the estate tax and the gift tax credit in the estate tax computation are increased by the higher valuation of the gifted property. One common misperception arising from this simultaneous increase in the tax and credit is that the net effect of a gift revaluation is negligible.

Estate Tax Effect. The fallacy of this perception can be illustrated by returning to the earlier example in which a donor/decedent with an estate of $2 million was assumed to make inter vivos gifts to his daughter of $200,000 and $500,000. If the Service were to revalue the gifts for estate tax purposes at $450,000 and $1,250,000, respectively, the estate would owe an additional $129,200 of tax. The calculation of this additional estate tax is shown below.

Taxable estate		$2,000,000
Plus: Adjusted taxable gifts made in post-1976 years:		
Revalued gift in 1994	$450,000	
Revalued gift in 1995	1,250,000	
Less: Annual exclusions	(20,000)	1,680,000
Total taxable transfers		$3,680,000
Tentative tax on total transfers		
($1,290,800 + 55% over $3,000,000)		$1,664,800
Less: Allowable credits:		
Gift taxes payable on post-1976 taxable gifts		
($555,800 + 45% over $1,500,000) − $192,800	$444,000	
Unified transfer tax credit	192,800	(636,800)
Estate tax after revaluation		$1,028,000
Less: Estate tax before revaluation		898,800
Estate tax deficiency		$ 129,200

Revaluation, in this example, increases the estate tax by approximately 14 percent and may subject the estate to a penalty under Section 6662(g) for the substantial valuation understatement of the donor/decedent's adjusted taxable gifts.[24] A similar effect may occur when gifts for which no gift taxes

[24] Under Section 6662(g), a penalty for substantial estate or gift tax valuation understatement may be imposed if the value of any property claimed on an estate or gift tax return is 50% or less than the amount determined to be correct. A penalty is not imposed, however, unless the understatement results in a tax underpayment greater than $5,000.

were assessed or paid are revalued for purposes of computing a gift tax on a subsequent gift.

Gift Tax Effect. To illustrate the effect of revaluation on subsequent gift tax, consider a donor who gives an asset with a reported value of $500,000 to his son in 1995. Six years later, when the general three-year statutory limitation period on the 1995 gift has expired, he makes a second gift of an asset with a reported value of $700,000. Absent any revaluation of the first gift by the Service, the tax on the $700,000 gift would be $226,800, calculated as shown below.

Reported value of gift in 2001		$ 700,000
Less: Annual exclusion		(10,000)
Taxable gift in 2001		$ 690,000
Plus: 1995 taxable gift:		
Reported value of gift in 1995	$500,000	
Less: Annual exclusion	(10,000)	490,000
Total taxable gifts		$1,180,000
Tentative tax on total taxable gifts ($345,800 + 41% over $1,000,000)		$ 419,600
Less: Gift tax calculated on 1995 gift ($70,800 + 34% over $250,000)		(152,400)
Tentative tax on 2001 gift		$ 267,200
Less: Remaining unified transfer tax credit:		
Total credit available	$192,800	
Less: Credit used in 1995	(152,400)	40,400
Gift tax due 2001 gift		$ 226,800

Note that the first gift of $500,000 is not protected by Section 2504(c) from revaluation after the general three-year statutory period because no gift tax was assessed or paid on it. Thus, if during an audit of the second gift, the Service revalues the $500,000 gift at $1,250,000, the tax on the $700,000 gift would increase by $78,300 to $305,100. The calculation of this gift tax deficiency is shown below.

Reported and accepted value of gift in 2001		$ 700,000
Less: Annual exclusion		(10,000)
Taxable gift in 2001		$ 690,000
Plus: 1995 taxable gift:		
Revalued gift in 1995	$1,250,000	
Less: Annual exclusion	(10,000)	1,240,000
Total taxable gifts		$1,930,000
Tentative tax on total taxable gifts ($555,800 + 45% over $1,500,000)		$ 749,300
Less: Gift tax calculated on 1995 gift ($345,800 + 41% over $1,000,000)		(444,200)
Tentative tax on 2001 gift		$ 305,100
Less: Remaining unified transfer tax credit:		
Total credit available	$192,800	
Less: Credit used in 1995	(192,800)	0
Gift tax due on 2001 gift after revaluation		$ 305,100
Less: Gift tax due on 2001 gift before revaluation		226,800
Gift tax deficiency		$ 78,300

In this example, revaluation of the first gift increases the tax on the second gift by about 35 percent and may subject the donor to a substantial valuation understatement penalty under Section 6662(g). These problems, however, could have been avoided had a gift tax been paid for 1995 because Section 2504(c) would have prohibited the Service from revaluing the first gift after the expiration of the general three-year statutory limitation period.

To effect a payment of gift tax for 1995, the donor could have either transferred another asset having a reported value in excess of $120,000 or increased the reported value of the $500,000 gift to an amount greater than $610,000. Either of these acts would have required payment of a gift tax because the total value of the gifted property reported on the 1995 gift tax return would have exceeded the sum of the $10,000 annual gift exclusion and $600,000 unified transfer tax credit equivalency.[25] To avoid a penalty for substantial valuation understatement during the general three-year statutory limitation period, however, the reported value of the gifted property for 1995 would have to exceed 50 percent of the amount determined by the Service to be correct. Thus, in this example, the total reported value of the gifted property for 1995 would have to exceed $685,000 (($1,250,000 + $120,000) × 50%) if two assets were transferred and $625,000 ($1,250,000 × 50%) if only one asset was transferred.

Planning for Gift Revaluations

In planning for the possible effects of gift revaluation, both its likelihood of occurrence and potential tax consequences should be assessed. With respect to the likelihood of occurrence, the preceding court cases indicate that valuation disputes are more likely to occur for gifts involving closely-held corporate stock, mineral rights, land, and other property not actively traded on an established market. Greater documentation of the value of these types of assets consequently is required.

Closely-Held Corporate Stock. For closely-held corporate stock, professional appraisals which consider the following factors, as listed in Reg. §§25.2512-2 and 25.2512-3 and amplified by Rev. Rul. 59-60,[26] should be sought.[27]

1. The nature of the business and the history of the corporation from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in which the corporation operates.
3. The book value of the stock and the financial condition of the corporation.
4. The earnings capacity of the corporation.
5. The dividend-paying capacity of the corporation.
6. The existence of goodwill and other intangible value attributable to the corporation.
7. Other sales of the stock and the size of the block of stock being valued.
8. The market price of stocks of corporations engaged in the same or similar lines of business that are actively traded in a free and open market, either on an exchange or over the counter.

Other Property. For other types of property, such as mineral rights and land, professional appraisals again should be sought. The specific factors considered in these appraisals, however, will depend largely on the nature of the gifted property. Among some of the factors that may be relevant are the following items.[28]

1. The condition, location, and income production of the property.
2. The economic outlook and prospect of proposed favorable or unfavorable zoning changes affecting the property.
3. The assessed value of the property for local tax purposes where the relationship of such value to fair market value is ascertainable.
4. The capitalization of current rentals or royalties.
5. The amount of any nonrecourse mortgage loans secured by the property.
6. The existence of easements on the property or an outstanding lease for a term of years.
7. Recent attempts to dispose of the property including offers before and after the gratuitous transfer.
8. Other sales of similar property located nearby.
9. The size of the gifted ownership interest in the property.

Estimating the Tax Effect. Although numerous other factors may affect the valuation of gifted property, the two foregoing lists can be used as starting points in estimating the possible range of values to which such property might be assigned by the Service. From this range, the potential tax consequences associated with revaluation can be calculated by assigning appropriate probabilities to each value within the range. The liquidity requirements of these tax consequences can then be compared to the liquid assets held by or accessible to the

[25] See note 13, supra.
[26] Rev. Rul. 59-60, 1959-1 CB 237.
[27] For more detailed discussions regarding the valuation of a closely held business, see Hitchner, J.R., "Valuation of Closely Held Businesses," *The Tax Advisor* (July 1992), pp. 471-479; Hitchner, J.R., and G. Roland, "Marketability and Control Govern Value of Family Businesses," *Taxation for Accountants* (January 1994), pp. 24-28.
[28] For more complete discussions regarding general valuation principles, see Internal Revenue Service, *IRS Valuation Guide for Income, Estate and Gift Taxes* (1994, CCH Incorporated, Chicago, IL); Campfield, R.W., M.B. Dickinson, Jr., and W.J. Turnier, *Taxation of Estates, Gifts and Trusts, 19th ed.*, Chapters 9-14 (1994, CCH Incorporated, Chicago, IL).

donor and his/her estate to ensure that, in the event revaluation becomes a reality, adequate cash is available to pay any assessed tax deficiency. Lastly, the permanent records of the donor should be reviewed for completeness and to verify that the actual value of the gifted property reported on the gift tax return is realistic.[29]

Conclusion

Although many taxpayers and their advisers assume that Section 2504(c) protects a gift from revaluation by the Service after the expiration of the general three-year statutory limitation period, such an assumption overlooks two important exceptions. First, Section 2504(c) does not prohibit revaluation of prior gifts when no gift tax was assessed or paid. For purposes of this rule, the reduction in a gift tax liability by use of the annual gift exclusion and unified transfer tax credit is not considered an assessment or payment of gift tax. Second, Section 2504(c) does not bar the revaluation of prior gifts for purposes of determining a current estate tax. This rule is applicable to the determination of a current estate tax without regard to whether the statutory limitation period on the gift has expired or a gift tax has been assessed or paid.

To mitigate potential gift revaluation problems, the nature of the transferred property should be considered. Because the likelihood of revaluation problems is greater for gifts of property which are not actively traded on an established market and for which values are difficult to determine, inter vivos transfers of these types of assets should be given special attention. In general, revaluation problems arising from transfers of these types of assets can be confined for purposes of subsequent gift tax determinations to the three-year statutory limitation period simply by paying a gift tax on the transfer. Donors contemplating gifts of these types of assets, therefore, may wish to coordinate such gifts with transfers of other property in order to ensure that the total reported value of the gifted property generates a gift tax liability in excess of the annual gift exclusion, unified transfer tax credit, and other applicable tax credits.

With respect to estate tax determinations, several precautions can be taken to minimize later revaluation problems. First, permanent records documenting the value of the gifted property can be stored at locations accessible to future heirs, personal representatives, and executors after the donor/decedent's death. Among the items included in these records should be the credentials and addresses of any appraisers, attorneys, accountants, or other professionals involved in the original transfer. Second, the liquidity needs of the estate can be estimated for a range of potential gift valuations. Based on these estimated liquidity needs, the asset holdings of the donor/decedent can then be shifted to ensure that adequate cash will be available to pay any potential tax deficiency resulting from a revaluation. Third, the tax risks and potential consequences of a revaluation can be explained to future heirs, personal representatives, executors, and others who will be affected by the donor/decedent's death in order to facilitate future dealings with the Service.

[29] Also see Section 6662(g) and related sections of Chapters 68 and 75 regarding penalties for valuation understatements of gifted property.