RETURN PREPARATION

Gift Tax Returns—Common Mistakes

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Introduction

Gift tax returns are seductively simple. It's not a long return, the template that the return requires be filled in does not seem particularly complex, so how hard can it be? Preparing a gift tax return correctly is not an easy task and professionals who don't prepare them regularly and with care can easily make a myriad of mistakes. There are so many areas of uncertainty, layers, and nuances that it's virtually impossible for anyone preparing a return to not receive comments from a reviewer. While practitioners have seen a decline in gift tax return filings because of the large current lifetime exemptions, the fact that the current exemption will be cut in half in 2026, and perhaps earlier by a new administration, bolstered by the fact that there will be no claw-back if the high exemption is used, practitioners should expect to see an uptick in gift tax filings before the 2020 election.

Common Form 709 Errors

Some of the most common mistakes/oversights are:

1. ***Incomplete/incorrect summary of previously filed returns and exemption amounts used*** being reported on Schedule B of 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 the generation-skipping transfer (GST) allocation handled properly? Were there front-loaded gifts to Code Sec. 529 plans that could affect current reporting?
2. ***Failure to report charitable gifts.*** This is an incredibly common oversight. For almost every gift tax return there is an intent to toll the statute of limitations by meeting the adequate disclosure rules. If charitable gifts are not

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reported as required, might that negate meeting the adequate disclosure rules and tolling the statute of limitations for an audit? If a donor is making gift to a trust like a grantor-retained annuity trust (GRAT), those trusts are structured as very small-dollar-value gifts. Consequently, one may give $10 million to a GRAT, but the current value of that gift can be only a couple of thousand dollars for gift tax purposes. And, as the preparer, you are going to report that value. But, if the client made $20,000 of charitable contributions, and the preparer is not aware of that or doesn't report it, you may now have a problem with the statute of limitations because the gifts have been under-reported and therefore, might not fulfill the disclosure requirement for all transfers. Make sure to review any charitable gifts.

3. ***Reporting gifts in the wrong section of Schedule A.*** Often practitioners report gifts as current gifts when in fact there are GST implications. There are different categories of transfers that must be reported in different parts of the form and too often practitioners are not cautious about properly characterizing where these are reported. For example, 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. 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 the value of the money (or property) received is less than the value of what was sold or exchanged. Another category of transfers to report involves transfers that are not subject to the gift tax. And yet another category of gifts to report on Form 709 are gifts subject to the GST tax. These 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, of an interest in property, 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. These indirect skips must be reported separately.
4. ***Incomplete summary of the prior gift tax returns.*** 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. ***Transfers to Code Sec. 529 plans.*** 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 Errors

The GST tax is complicated and many of the rules not intuitive. Further, with the growth of the estate tax exemption to $5 million inflation adjusted, and more recently to $10 million inflation adjusted ($11.4 million for 2019), 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.*** For example, 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.
2. ***Allocation of GST exemption.*** The most common mistakes on gift tax returns involve the allocation of GST exemption. The GST exemption is the same amount as the lifetime gift tax exemption, currently $11,400,000. You want to utilize this exemption for transfers that skip a generation. For example, if a grandparent is gifting to a grandchild either outright in excess of the annual exclusion or in trust, apply GST exemption to that transfer. A common mistake occurs when the preparer of the gift tax return assumes that the annual exclusion for gifting (currently $15,000) also applies automatically to any generation skipping transfer. That is not the case if the generation-skipping transfer was, for example, a $15,000 gift to a trust of which grandchildren are beneficiaries. There is an annual exclusion for generation-skipping transfer purposes but there are a lot more hurdles to get over before that same transfer that qualifies for the gift tax annual exclusion would also qualify for GST annual exclusion. Transfers to most trusts, especially perpetual, long-term dynastic trusts, do not qualify for the GST annual exclusion because one of the requirements to utilize this annual exclusion is that the trust assets would have to be includible in the skip person's (grandchild or more remote descendant) estate if they die. If that element is not present, the GST annual exclusion will not apply.
3. ***GST exemption allocation is needed/desired on most trusts.*** This is another area in which mistakes are frequently made on gift tax returns. 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. There is "automatic allocation" and there is "affirmative allocation" of GST exemption. Automatic allocation is a concept that's been around since 2001. If the trust to which the transfer is being made satisfies the definition of a GST trust, then transfers to that trust qualify for automatic allocation. Some preparers may read the trust document, conclude that the terms meet the definition of a GST trust and, therefore, automatic allocation applies and indicate that on Schedule D of the gift tax return. Other preparers may not want to rely on whether they made the correct determination that the trust is a GST trust since these rules are quite intricate and subject to much interpretation. They may affirmatively make an allocation of GST exemption via a notice of allocation and opt out of automatic allocation or utilize automatic allocation in conjunction with an election to treat the trust as a GST trust and a notice of allocation ("belt and suspenders" approach).

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4. ***Language must anticipate audit.*** When a notice of allocation is used, it should include language that covers the possibility of the value of the gift being changed upon audit so that the amount of GST exemption allocated fluctuates with that change in value. Even though some of these GST elections we've discussed (electing to be a GST trust, opting out of automatic allocation) can be made once and remain in effect going forward for that respective trust, it's helpful to list each trust to which transfers are being made and state affirmatively what GST elections have been made not just for tax reasons, but as a form of provenance and clarity for others in the future who may be working to discern and

decipher the trust. Providing minimal information is counterintuitive and can breed frustration. Be clear and transparent on the steps you take/elections you make in this area.

Disclosure and Form 709 Errors

When filing a gift tax return, you want to 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 you will not start the statute of limitations for that return. Reg. §301.6501(c)-1(e) and (f) outlines what is required to be provided for a gift to be considered adequately disclosed. In addition, it is good practice when any transfer is made into a trust, to attach the trust document to the gift tax return regardless of whether that trust document was attached to a prior year gift tax return.

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Lack of sufficient supporting documentation included with the gift tax return may not start the statute of limitations and may trigger follow-up communications from the IRS. An approach that might be useful is 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. Some practitioners will purposely not attach a copy of a trust document if it was disclosed in a prior gift tax return. Other practitioners prefer to make the disclosures in each year's gift tax return complete and comprehensive. No doubt agents appreciate this as it avoids their having to scour for prior returns. But, it can also be useful in the future when another practitioner prepares a future return or evaluates prior returns for various purposes.

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 limitations 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.

Conclusion

Gift tax returns are often incredibly complicated with layers of issues, technical decisions, and disclosure requirements. Don't treat them lightly. Far too many times, a taxpayer will "bargain shop" for an accountant to find the cheapest preparer, rather than the person most competent to do it. This practice should be viewed by practitioners as the danger that it is. If a client will not permit you to handle a Form 709 filing in the manner you as a professional believe necessary, pass on accepting the work. Familiarize yourself with gift tax guidelines and rules carefully to ensure nothing is overlooked.