GIFTING AND INHERITANCE

Please Note. Corrections for all chapters and the *What's New Supplement* are available at taxworkbook.com (User Name: class2001 Password: class2001)

INTRODUCTION

Income tax planning has always been an important part of tax planning for wealth transfers. As the estate tax is phased out, the income tax consequences of wealth transfer become even more important relative to the estate and gift tax consequences. For most wealth transfers, the most significant income tax issue is the basis of the transferred asset in the hands of the recipient. This chapter discusses the income tax planning opportunities for wealth transfer transactions.

Whether or not a taxpayer engages in income tax planning for wealth transfers, the tax practitioner must determine the basis of assets to properly compute depreciation and to report gain or loss on sale or other transfer of an asset that is received by gift or inheritance. It is often difficult to determine the basis of assets in the hands of a taxpayer who received the asset by gift or inheritance. Common reasons for that difficulty include:

1. The donor does not know the basis before the transfer.

2. The basis information on gift or estate tax returns is not communicated to the recipient of the property.
3. No gift tax return or estate tax return is required and no other documents are available to determine the recipient's basis.
4. The adjustment for gift taxes paid by the donor has not been computed.

BASIS OF ASSETS RECEIVED AS A GIFT

A gift of cash does not raise any income tax basis issues since the income tax basis of cash is always its face value. By contrast, the basis of noncash assets received by gift is generally the donor's basis in the asset. There are two exceptions to the general rule.

EXCEPTION 1

For purposes of calculating a loss on a subsequent taxable transfer by the donee, the donee's basis is the lesser of:

a. The donor's basis, or
b. The fair market value of the asset on the date of the gift

> **Observation.** This exception will cause the basis of property to be other than the donor's basis only if the asset's fair market value is less than the donor's basis on the date of the gift.

Example 1. Tony gave $10,000 of stock to his sister Beth. Tony's basis in the stock was $11,000. If Beth later sells the stock for more than $11,000, her basis for calculating gain is $11,000. If she later sells the stock for less than $10,000, her basis for calculating loss is $10,000. If she sells the stock for $10,000 or more, but not more than $11,000, she has no gain or loss to report.

Planning. In many cases of a gift of an asset that has a basis greater than its fair market value, the donor and donee will pay less income tax if the donor sells the asset and gives the cash proceeds to the donee.

Example 2. Assume the stock that Tony gave to Beth in Example 1 was worth $10,400 when Beth sold it a year after the gift. Beth has no gain or loss to report on her income tax return. By contrast, if Tony had sold the stock before making the gift, he would recognize a $1,000 loss. If he gave the $10,000 cash to Beth and she purchased the same stock and sold it a year later for $10,400, she would recognize $400 of gain. Between them, Tony and Beth report a net loss of $600 rather than no gain or loss.

However, in a few cases of a gift of an asset that has a basis greater than its fair market value, the donor and donee will pay less income tax if the donor does not sell the asset.

Example 3. Assume the stock that Tony gave to Beth in Example 1 was worth $11,600 when Beth sold it a year after the gift. Further, assume that Tony is in the 15% marginal income tax bracket and Beth is in the 27.5% marginal income tax bracket.

If Beth receives the stock as a gift and sells it a year later for $11,600, she recognizes a $600 gain, which is taxed at the lesser of her 27.5% marginal tax rate or the 20% rate for long-term capital gains. She pays $120 of tax on that gain. By contrast, if Tony sold his stock for $10,000 and gave the $10,000 to Beth, and she used it to buy the same stock and sold it a year later for $11,600, she would pay $320 of income tax on her $1,600 of gain. Tony would report a $1,000 loss on the sale of the stock, that would save him $150 of income taxes. Their net income tax liability is $320 – $150 = $170, which is $50 more than Beth's income taxes from sale of the stock received by gift.

> **Practitioner Note.** If the donor has capital losses in excess of capital gains in the year of the gift, a sale of the asset and gift of the cash will result in the lower basis for the donee without an immediate loss deduction for the donor.

EXCEPTION 2

If gift taxes are due on the transfer, the donee's basis in the asset is the donor's basis increased by the gift tax attributable to any appreciation in the value of the asset.

Example 4. Jane gave Larry 100 shares of Donor.com stock with a fair market value of $200 per share. Larry paid $10 per share for the stock when he bought it ten years ago. The gift exceeded Jane's annual exclusion and her applicable exclusion amount, and she was required to pay $8,000 of federal gift tax for the transfer.

Larry's basis in the stock is calculated as follows:

Jane's basis (100 shares × $10 per share)	$1,000
Gift tax attributable to the appreciation	
($19,000 ÷ $20,000) × $8,000	7,600
Larry's basis	$8,600

HOLDING PERIOD

The donor's holding period is added to the donee's holding period to determine if the donee's gain or loss is short- or long-term capital gain or loss.

Example 5. If Larry from Example 4 sold his Donor.com stock for $20,000 the week after Jane gave it to him, his $11,400 gain ($20,000 – $8,600) is long-term capital gain because her ten-year holding period is added to his one-week holding period.

BASIS OF ASSETS RECEIVED FROM A DECEDENT

> **Please Note.** The Economic Growth and Tax Relief Act of 2001 made significant changes to the rules that determine basis of assets received from a decedent. Those changes are effective for transfers in 2010. They are discussed and illustrated in the New Legislation chapter at page 529. The following discussion covers the basis rules in effect through 2009.

INTRODUCTION

Assets owned by a decedent at the time of death can be transferred to survivors by several means. Some assets pass directly to survivors by operation of nonprobate laws:

1. Property owned as joint tenants passes to the surviving joint tenant(s) by operation of property law.
2. Assets in a trust pass to the beneficiaries of the trust by operation of trust law.
3. Assets in a retirement account pass to the named beneficiaries by operation of contract law.

4. The proceeds from a life insurance policy pass to the beneficiaries by operation of contract law.

Some assets pass through a probate estate before they are transferred to the person who is entitled to the asset. That person could be determined in several ways:

1. If there is no will, the rules of intestate succession for the state of the decedent's domicile determine who receives the assets.
2. If there is a valid will, its terms will determine who receives the assets.
3. In some cases, assets pass from a probate to a trust and then to the person who is entitled to the asset. The transfer from the trust to the ultimate beneficiary could occur shortly after the decedent's death or many years after the decedent's death.

No matter what route an asset follows to reach the ultimate beneficiary, the income tax basis of the asset must be tracked through that route to the ultimate beneficiary.

GENERAL RULE

I.R.C. §1014(a)(1) gives the person, estate or trust that receives property from a decedent a basis in the property equal to its value at the date of the decedent's death. This general rule applies to any property that is acquired or passed from the decedent, which is broadly defined to include any property that is required to be included in the decedent's gross estate for purposes of the estate tax rules [I.R.C. §1014(b)].

Example 6. At the time of her death, Gladys owned 100 shares of PQR stock that had a $10,000 fair market value and a $7,000 basis. Her will gave the stock to her son, Ben. The PQR stock passes from Gladys to her probate estate and the stock has a $10,000 basis in the estate. (The basis in Ben's hands is discussed later under "Basis of Assets Distributed from an Estate or Trust.")

Practitioner Note. The decedent's estate for estate tax purposes is not necessarily identical to the decedent's probate estate. Property that avoids the probate process may be included in the estate for estate tax purposes and may therefore get the date-of-death basis adjustment.

Example 7. Kim Burley titled her home in the names of her daughter and herself as joint tenants with right of survivorship. Upon her death, the title to her home passed by property law to her daughter without going through the probate process. For estate tax purposes, however, the value of the home was in Kim's estate. Therefore, Kim's daughter's basis in the home is its fair market value on the date of Kim's death.

Community Property

Also included in the date-of-death value rule is property owned by a surviving spouse as community property if at least one-half of the community property was included in the decedent's estate for estate tax purposes [I.R.C. §1014(b)(6)]. This rule applies whether or not the decedent's half goes to the surviving spouse.

Example 8. Russ and Fran Ticke are married and own a parcel of real estate as community property without the right of survivorship. Russ died in 2000 and his will passed his half of the community property to his son, Woody. Since half of the community property is in Russ's estate for estate tax purposes, both halves of the community property get a date-of-death value basis.

Both halves would also get a date-of-death value basis if the property were survivorship community property that passed **both** halves to Fran by operation of property law.

Observation. The basis rules are not as favorable for property that is owned by spouses as a joint tenancy created after 1976. The surviving spouse will get a date-of-death basis in only the half that passes through the estate of the first spouse to die. The half owned by the surviving spouse before death does not get adjusted to the date-of-death value.

EXCEPTIONS TO THE GENERAL RULE

There are several exceptions to the general rule. Most of the exceptions are designed to prevent taxpayers from abusing the general rule to get an increase in income tax basis.

Gifts Within One Year of Death

If a taxpayer gives appreciated property to a decedent within one year before the decedent's death and the property passes back to the taxpayer or the taxpayer's spouse as a result of the decedent's death, the taxpayer (or taxpayer's spouse) has a basis in the property equal to the decedent's basis (the carryover basis from the donor) [I.R.C. §1014(e)]. Appreciated property is defined as property with a fair market value in excess of its basis on the day it is transferred to the decedent.

Property Representing Income in Respect of a Decedent (IRD)

The date-of-death-value basis rule does not apply to property that represents the decedent's right to receive income. The most common items of income in respect of a decedent are accounts receivable of a cash method taxpayer, retirement accounts, and deferred gains on installment receivables. Since the recipient of property that represents income in respect of a decedent does not get an adjusted basis, the recipient will recognize income when the recipient receives the payment from the property right.

Example 9. Krista Ward owned an installment contract at the time of her death. The balance due on the contract was $100,000, and her gross profit ratio was 60%. The original sale price was $200,000 and Krista's basis was $80,000, for a gross profit of $120,000. Krista's estate received a $10,000 payment on the contract, of which $9,000 was interest and $1,000 was principal.

Krista's estate must report the $9,000 of interest as ordinary income, and 60% of $1,000, or $600, as capital gain.

If the contract is distributed to a beneficiary (other than the buyer under the contract) in satisfaction of a specific bequest of the installment obligation, the estate will not recognize the gain remaining at the time of the distribution, and the beneficiary will recognize gain as the remaining payments are received.

Example 10. If Krista's estate in Example 9 had distributed the contract to her son Marvin under a specific bequest before the payment was received, the estate would recognize no income, and Marvin would recognize the $9,000 of ordinary income and $600 of capital gain.

If the contract is distributed to the buyer under the contract, the estate must recognize all the remaining gain on the contract.

Example 11. If Marvin was the buyer under the contract and received the contract as a distribution from the estate before any payments were made, the estate would have to recognize 60% of $100,000, or $60,000, of capital gain at the time of the distribution.

If the contract is distributed in satisfaction of a bequest of money, income, or other specific property, the estate must recognize all of the gain remaining at the time of distribution.

Example 12. If Marvin was not the buyer under the contract but received the contract from the estate in satisfaction of a bequest of $100,000, the estate would have to recognize $60,000 of capital gain at the time of the distribution.

Marvin would have a $100,000 basis in the contract. Therefore, upon receiving the $10,000 payment, he would report the $9,000 of interest as ordinary income but would not have to report any gain from the $1,000 principal payment.

S Corporation Stock

Taxpayers who receive S corporation stock due to the death of a shareholder after August 20, 1996, must reduce basis in the stock for any income in respect of a decedent in the corporation at the time of the first shareholder's death [I.R.C. §1367(b)(4)(B)].

Example 13. Julie inherits one-third of the stock in Jayco, a cash method S corporation, from her father, Jake. The fair market value of this inherited stock at the date of Jake's death is $1,000,000. There is also $450,000 of accounts receivable at the date of Jake's death. If Jake died on or before August 20, 1996, Julie's basis would be $1,000,000. If Jake died after August 20, 1996, Julie's basis would be $850,000 ($450,000 ÷ 3 = $150,000 reduction).

Alternate Valuation Date Election

If the executor of the decedent's estate has elected to value the assets in the estate on the alternate valuation date (six months after the date of death) under I.R.C. §2032, then the value of assets on that date is the basis of the assets in the hands of the taxpayer that receives the property from the decedent [I.R.C. §1014(a)(2)].

Special-Use Valuation

If the executor of the estate elects to value the qualifying assets in the estate under the special-use valuation rules of I.R.C. §2032A, the special-use value is the basis of the qualifying assets in the hands of the taxpayer who receives the property from the decedent [I.R.C. §1014(a)(3)].

Qualified Conservation Easements

The portion of a qualified conservation easement that is excluded from the decedent's estate under I.R.C. §2031(c) has a carryover basis from the decedent [I.R.C. §1014(a)(4)]. Therefore, if 40% of the value of property is excluded, then 40% of the decedent's basis will be carried over and 60% of the value of the property will receive a date-of-death value basis.

Example 14. Barry Basis paid $200,000 for land from which he later donated a conservation easement. The conservation easement was valued at 30% of the value of the property without the easement. Therefore, Barry's basis in the interest he retained is 70% of $200,000 = $140,000. At the time of Barry's death, the interest Barry retained in the land (all the rights to the property except the right to develop it) is worth $300,000. Under I.R.C. §2031(c), Barry's estate elects to exclude 40% of the $300,000 value. The estate's basis in the interest Barry retained is $236,000, calculated as follows:

Fair market value of 60% included in estate ($300,000 × 60%)	$180,000
Barry's basis in the 40% excluded from the estate ($140,000 × 40%)	56,000
Estate's basis	$236,000

Depreciation Claimed before Date of Death

Property that is acquired from the decedent by reason of joint tenancy, tenancy by the entirety, or tenancy in common, is subject to a rule that requires the basis to be reduced by any depreciation claimed by the recipient before the decedent's death [I.R.C. §1014(b)(9), last three sentences].

Example 15. Mel acquired depreciable rental property in 1998 for $150,000 and took title to it as tenants by the entirety (upon one spouse's death, title passes by law to the surviving tenant, instead of via the decedent's will) with his wife, Mary. They do not live in a community property state. Prior to Mel's death in 2000, depreciation deductions of $5,000 had been taken. The fair market value (FMV) of the property at the time of Mel's death is $175,000. In May 2001, Mary sells the property to an unrelated party for $175,000. Her basis in the property is calculated as follows:

FMV of Mel's interest ($175,000/2)	$ 87,500
Mary's basis in her half ($150,000/2)	75,000
Less 1/2 depreciation taken before Mel's death	(2,500)
Mary's basis	$160,000

Mary has a $15,000 gain computed as follows:

Selling price	$175,000
Less Mary's basis	(160,000)
Gain	$ 15,000

Practitioner Note. Since $2,500 of the gain is due to a basis reduction caused by depreciation, that $2,500 of gain is ordinary income under the I.R.C. §1245 depreciation recapture rules. The remaining $12,500 of gain is I.R.C. §1231 gain.

HOLDING PERIOD

General Rule

Property acquired from a decedent that receives a new tax basis equal to the date-of-death value under the I.R.C. §1014 rules discussed is generally treated as being held for more than a year by the person who received the property from the decedent, regardless of the actual holding period [I.R.C. §1223(11)]. Therefore, most property will meet the holding period requirement of I.R.C. §1231 if it passes through a decedent's estate.

Example 16. Grace Period bought 100 shares of XYZ stock for $1,000 on January 15, 2001. When Grace died on March 20, 2001, the 100 shares were worth $10,000. Her will gave the XYZ stock to her son, Ian. Ian sold the stock on December 15, 2001, for $25,000. His gain is calculated as follows:

Amount realized on sale	$25,000
Date-of-death value basis	(10,000)
Gain on sale	$15,000

To determine whether the gain is short- or long-term, Ian is treated as holding the stock for more than a year and gets long-term capital gain treatment of the $15,000 of gain.

I.R.C. §1231 Property

The automatic more-than-a-year holding period applies to I.R.C. §1231 property for purposes of meeting the holding period requirement of I.R.C. §1231(b)(1). Therefore, most property used in a trade or business gets I.R.C. §1231 treatment regardless of its holding period if it is acquired from a decedent, and it gets an I.R.C. §1014 basis.

Example 17. Matthew inherited a tractor from his father on May 1, 2001. His father had purchased the tractor on March 1, 2001. Matthew used the tractor in his farming business until he sold it on December 15, 2001.

Matthew is treated as holding the tractor for more than a year under I.R.C. §1223(11). Therefore, the sale of the tractor qualifies for I.R.C. §1231 treatment and is reported on Part I of Form 4797.

Livestock

I.R.C. §1223(11) does **not treat** taxpayers as automatically meeting the 12-month or 24-month holding period for **livestock** under I.R.C. §1231(b)(3) [Rev. Rul. 75-361, 1975-2 C.B. 344]. Consequently, livestock that is acquired from a decedent **must** be held for 12 months or more (24 months or more for cattle and horses) to qualify for I.R.C. §1231 treatment.

Example 18. Matthew inherited a boar from his father on May 1, 2001. His father had purchased the boar on March 1, 2001. Matthew used the boar in his farming business until he sold it on December 15, 2001.

I.R.C. §1223(11) does not apply to the boar. Therefore, the boar is not I.R.C. §1231 property. The sale would be reported on Part II of Form 4797.

BASIS OF ASSETS DISTRIBUTED FROM AN ESTATE OR TRUST

When an estate or trust distributes property to a beneficiary, the beneficiary's basis in the asset is the same as the estate's or trust's basis in the asset, increased by any gain recognized on the distribution and decreased by any loss recognized on the distribution.

SPECIFIC BEQUEST

If assets are distributed to satisfy a specific bequest, the estate or trust does not recognize gain or loss on the distribution, so the beneficiary's basis is the same as the estate's basis in the asset.

Example 19. Glady's will gave her 100 shares of PQR stock to her son Ben. Her estate's basis in the stock is its $10,000 fair market value on the date of death. When the estate distributes the shares of stock to Ben, he will acquire the same $10,000 basis in the stock.

Practitioner Note. The asset's basis would be decreased by any depreciation, depletion, or amortization while the estate held the property, and increased by any capital improvements while the estate held the asset. Those changes will be reflected in the basis carried over to the beneficiary.

PECUNIARY BEQUEST

If the executor of the estate uses property to satisfy an obligation to distribute a fixed amount of money, the estate will have to recognize any gain or loss on the distribution. Therefore, the beneficiary's basis in the property will be the estate's basis adjusted by the gain or loss recognized by the estate.

Example 20. Mel died in 2001. In his will, he left $10,000 to his sister, Brenda. With the agreement of Brenda, the estate distributes XYZ Corporation common stock with a basis of $9,500 and a fair market value of $10,000 to satisfy the bequest. The estate will recognize a capital gain of $500. Brenda's basis in the shares is the basis in the hands of the estate immediately prior to the distribution ($9,500) plus the gain recognized by the estate on the distribution ($500), for a total of $10,000.

> **Practitioner Note.** The preparer of the estate's Schedule K-1 (Form 1041) should note the beneficiary's basis in the distributed property as a memo item on the beneficiary's copy of Schedule K-1 (Form 1041), particularly if basis information is not conveyed to the beneficiary by the executor in a separate letter.

Related-Party Rules. The related-party rules of I.R.C. §267 prohibit the trust or estate from recognizing a loss on "sale or exchange" with a beneficiary. The related-party rules of I.R.C. §1239 require the estate or trust to report gain as ordinary income if the asset is depreciable in the hands of the beneficiary and is transferred in a "sale or exchange." Since the term "sale or exchange" is interpreted broadly, most transactions between the estate or trust and a beneficiary will be subject to both of the related-party rules. One statutory exception is a sale or exchange in satisfaction of a pecuniary bequest between an estate and a beneficiary of the estate [I.R.C. §§267(b)(13) and 1239(b)(3)].

Example 21. Assume the same facts as in Example 20 except that the XYZ stock had a basis of $11,000 in the estate. The estate is allowed to recognize the $1,000 loss ($11,000 – $10,000), and Brenda's basis in the stock is $10,000.

Example 22. If the distribution in Example 21 were from a trust instead of an estate, the trust would not be allowed to recognize the $1,000 loss. Brenda's basis in the stock would be $10,000, but I.R.C. §267(d) allows her to reduce any gain on a subsequent sale or exchange by the $1,000 loss that the trust was not allowed to recognize. For example, if Brenda sold the stock for $11,400, I.R.C. §267(d) allows her to reduce her gain as follows:

Sale price	$11,400
Basis	10,000
Gain	$1,400
Disallowed loss	1,000
Recognized gain	$400

> **Practitioner Note.** If the trust is a revocable trust that is a will substitute, it probably qualifies for the I.R.C. §645 election to be taxed as part of the estate (if there is a probate estate) or as the estate (if there is no probate estate). According to Prop. Reg. §1.645-1(e)(2)(i) and (3)(i), the trust is treated as part of the estate (or as an estate) for all purposes of subtitle A (I.R.C. §§1 through 1563) of the Internal Revenue Code. Therefore, the trust should be allowed to deduct losses from a distribution that satisfies a pecuniary bequest [I.R.C. §267(b)(13)].

DISTRIBUTIONS OF PROPERTY IN LIEU OF INCOME

Gain is recognized by the estate or trust when the estate or trust distributes property in satisfaction of a beneficiary's right to receive income. Loss recognition by an estate or trust is disallowed by the related-party rules. When the distribution is made, the fiduciary is deemed to have distributed cash in an amount equal to the trust income required to be distributed currently to the beneficiary who, in turn, is deemed to have used the cash to purchase the asset from the trust.

Example 23. William is entitled to an income distribution of $100,000 from the Mel Smith Estate in 2001. The trustee's records indicated that William was willing to accept 1,000 shares of XYZ Corp. common stock with a fair market value of $100,000 and a tax basis in the hands of the trust of $80,000 in satisfaction of his right under the trust instrument to receive $100,000 of income for 2001. No other distributions were made in 2001.

William will have a $100,000 tax basis in the stock and a holding period that begins on the date of distribution. The trust will have a $20,000 capital gain. The capital gain will be reported on Schedule D (Form 1041) as if the stock in XYZ Corp. had been sold to a third party.

SCHEDULE D (Form 1041)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1041 (or Form 5227). See the separate instructions for Form 1041 (or Form 5227).

OMB No. 1545-0092

2001

Name of estate or trust: *Estate of Mel Smith (Example 23)*

Employer identification number: *42 : 2671041*

Part II — Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see page 27)	(f) Gain or (Loss) (col. (d) less col. (e))	(g) 28% Rate Gain or (Loss) *(see instr. below)
6	*100 shares of XYZ stock*	*12/15/00*	*07/01/01*	*100,000*	*80,000*	*20,000*	

			(f)	(g)
7	Long-term capital gain or (loss) from Forms 2439, 4684, 6252, 6781, and 8824	7		
8	Net long-term gain or (loss) from partnerships, S corporations, and other estates or trusts	8		
9	Capital gain distributions	9		
10	Gain from Form 4797, Part I	10		
11	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 14, of the 2000 Capital Loss Carryover Worksheet	11	( )	( )
12	Combine lines 6 through 11 in column (g)	12		
13	**Net long-term gain or (loss).** Combine lines 6 through 11 in column (f). Enter here and on line 15 below ▶	13	*20,000*	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page 28 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page 26 of the instructions).

Part III — Summary of Parts I and II

			(1) Beneficiaries' (see page 28)	(2) Estate's or trust's	(3) Total
14	**Net short-term gain or (loss)** (from line 5 above)	14			
15	**Net long-term gain or (loss):**				
a	28% rate gain or (loss) (from line 12 above)	15a			
b	Unrecaptured section 1250 gain (see line 17 of the worksheet on page 29)	15b			
c	Total for year (from line 13 above)	15c		*20,000*	*20,000*
16	**Total net gain or (loss).** Combine lines 14 and 15c ▶	16		*20,000*	*20,000*

Note: *If line 16, column (3), is a net gain, enter the gain on Form 1041, line 4. If lines 15c and 16, column (2), are net gains, go to Part V, and* ***do not*** *complete Part IV. If line 16, column (3), is a net loss, complete Part IV and the* ***Capital Loss Carryover Worksheet,*** *as necessary.*

For Paperwork Reduction Act Notice, see the Instructions for Form 1041. Cat. No. 11376V **Schedule D (Form 1041) 2001**

Practitioner Note. William should be notified in writing that his basis in the shares is $100,000. The executor of the estate could include the basis in the cover letter to the beneficiary that is sent when transmitting the shares. The preparer could also include this information on Schedule K-1 (Form 1041) as a memo item.

Example 24. Assume the same facts as in Example 23, except the asset distributed is a machine on which the estate had claimed $25,000 of depreciation. It had a basis of $80,000 and a fair market value of $100,000. The distribution triggers I.R.C. §1245 recapture to the estate to be reported on Form 4797. Satisfaction of William's right to $100,000 of income by distributing the machine is treated as a distribution of $100,000 cash to William, who in turn is deemed to use the cash to purchase the machine from the estate at its $100,000 fair market value. William's basis in the machine is $100,000.

Form **4797** Department of the Treasury Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0184 **2001** Attachment Sequence No. **27**

Name(s) shown on return: *Estate of Mel Smith (Example 24)*
Identifying number: *42-2671041*

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	*Machinery*	*12/15/00*	*07/01/01*
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	*100,000*			
21	Cost or other basis plus expense of sale	21	*105,000*			
22	Depreciation (or depletion) allowed or allowable	22	*25,000*			
23	Adjusted basis. Subtract line 22 from line 21	23	*80,000*			
24	Total gain. Subtract line 23 from line 20	24	*20,000*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	*25,000*			
b	Enter the **smaller** of line 24 or 25a	25b	*20,000*			

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	*20,000*
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	*20,000*
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	*0*

ELECTION TO RECOGNIZE GAIN OR LOSS

The estate or trust can elect to recognize gain or loss on distributions from the estate [I.R.C. §643(e)(3)]. The election applies to all distributions made by the estate during the tax year, and can be revoked only with the consent of the Secretary of the Treasury. Since a beneficiary is a related party to the estate or trust, the estate or trust cannot recognize a loss on a distribution to a beneficiary.

The election affects not only the gain or loss reported by the estate or trust, but also the basis of the asset in the hands of the beneficiary, since any gain reported by the estate or trust is added to the beneficiary's basis.

Example 25. Nancy Green's will gave 100 shares of MNO stock to Nancy's son, Jim. At the time of Nancy's death, the stock was worth $75,000. When the estate distributed the stock in satisfaction of the specific bequest, it was worth $95,000. The estate had $20,000 of unused capital losses, of which half would pass to Jim and half would pass to his sister, Judy, at the termination of the estate. Since Judy already had carryover capital losses that she was not likely to use up, the estate elected to recognize the $20,000 of gain on the MNO stock it distributed to Jim. That gain was offset by the estate's $20,000 capital loss carryover. Jim's $95,000 basis in the stock is the estate's $75,000 basis, increased by the $20,000 gain recognized by the estate.

DISTRIBUTION OF INSTALLMENT OBLIGATIONS

If an estate or trust sells property on the installment basis, the installment method of accounting must be used to report the gain, unless the estate or trust affirmatively elects out of installment reporting. If the estate or trust subsequently distributes the installment note to the beneficiary, the distribution is a taxable disposition of an installment obligation, causing accelerated gain recognition to the estate or trust to the extent the fair market value of the installment obligation exceeds the basis of the obligation.

Example 26. The Mel Smith Trust sold a parcel of appreciated land for $100,000 on the installment basis in 1999. The land had a basis to the trust of $60,000. The trust received a $28,000 down payment and took a note for the remaining $72,000. The note called for 36 monthly payments of $2,000, plus interest at a fair market rate. After receiving 10 payments, the trustee distributed the note to Angie, the trust beneficiary, in 2001.

The distribution of the installment note to Angie is a taxable disposition of an installment obligation to the trust. Therefore, the trust recognizes gain to the extent that the fair market value of the note exceeds its adjusted basis.

Initial face value of the obligation	$72,000
Less payments received ($2,000 × 10)	(20,000)
Face value at time of sale	52,000
Less income not yet reported ($52,000 × 40%)	(20,800)
Basis of the note at time of sale	$31,200

Assuming the fair market value of the note is $45,000, the gain on the distribution is $13,800 ($45,000 – $31,200).

UNUSED TAX ATTRIBUTES UPON TERMINATION OF ESTATE OR TRUST

1. Unused capital losses
2. Unused net operating loss
3. Excess deductions in year of termination
4. Unused passive activity losses upon termination

UNUSED CAPITAL LOSS

In the year of termination of an estate or trust, the entire net capital loss is passed to the beneficiaries. The distribution of the capital loss will not be affected by the fiduciary having an ordinary income or an ordinary loss in the final year.

Practitioner Note. If a net capital loss carryover is distributed to the beneficiaries, the capital loss carryover worksheet should be used to compute the loss carryover to be allocated to the beneficiaries.

Example 27. In 2001, the Mel estate distributed all its assets to Brenda, the sole beneficiary. On July 1, 2001, the estate sold 100 shares of INC at a $5,000 short-term capital gain. The estate had a $15,000 long-term capital loss carryover from 2000. During 2001, Brenda had a $6,000 long-term capital gain and had no other capital gains or losses. Brenda also had $25,000 of ordinary income.

The $10,000 unused long-term capital loss will be distributed to Brenda. She uses $9,000 of that loss on her 2001 income tax return to offset her $6,000 long-term capital gain and $3,000 of ordinary income. She carries the remaining $1,000 long-term capital loss to her 2002 income tax return.

UNUSED NET OPERATING LOSS

If an estate or trust has a net operating loss (NOL) carryover in the year it is terminated, the NOL is distributed to the beneficiaries of the estate or trust.

Example 28. The Mel estate's final tax year ended November 30, 2001. It had a $25,000 net operating loss carryover after computing its taxable income for its final year. That $25,000 NOL is distributed to Brenda, the sole beneficiary. Brenda can claim the $25,000 NOL deduction on her 2001 income tax return and carry over to 2002 any portion of the $25,000 NOL that exceeds her modified taxable income. Brenda is subject to the same limitation on the number of years the NOL can be carried forward as the estate.

EXCESS DEDUCTIONS IN YEAR OF TERMINATION

If an estate or trust has deductions in excess of gross income in the year it is terminated, the excess is allocated to the beneficiaries of the estate or trust. This allocation is allowed only in the termination year and no other.

Example 29. The final Form 1041 of the Mel estate reflects the following:

Dividend income	$3,000	
Interest income	1,000	
Total income		$4,000
Administrative fees	$6,000	
Attorney and accountant fees	7,000	
Total deductions		$13,000
Excess deductions		$ 9,000

Brenda is the sole beneficiary. The excess deduction of $9,000 will be reflected on Brenda's Schedule K-1 (Form 1041) on line 13a, excess deductions on termination.

UNUSED PASSIVE ACTIVITY LOSSES UPON TERMINATION

In the year of termination of the estate or trust, the basis of a passive activity is increased by the amount of any suspended passive activity losses allocated to the activity.

Example 30. The Mel estate has one rental property, which is a passive activity. At the time of distribution the tax basis is $50,000 and the fair market value is $70,000. It has a suspended passive activity loss of $8,000.

The property is distributed to the sole beneficiary, Brenda. Her basis is computed as follows:

Estate's basis	$50,000
Suspended losses	8,000
Brenda's basis	$58,000

Practitioner Note. If the Mel estate had distributed the property to satisfy a pecuniary bequest, it would use the $8,000 suspended loss to reduce the $20,000 of capital gain to $12,000. Brenda would have a $70,000 basis in the property.

Observation. If, in the prior example, the property had been distributed to satisfy a pecuniary (fixed dollar) bequest of $70,000, the result would be different. The basis to the person receiving the pecuniary bequest would be $70,000 and, Mel estate would have a gain, as if they sold the property, of $12,000 ($70,000 – $50,000 – $8,000).

TREATMENT OF UNUSED TAX ATTRIBUTES UPON TERMINATION OF AN ESTATE OR A TRUST

Loss, Deduction, or Credit	Treatment
Capital losses	Passes through to beneficiaries with same character it had in estate or trust
Net operating losses (NOL)	Passes through to beneficiaries with same carryover limitation
Excess deductions in the year of termination	Passes through to beneficiaries as miscellaneous itemized deduction subject to 2% AGI limits. Only deductible by the beneficiary in final year of estate or trust
Passive activity losses	Adjust basis of property

UNIFORM BASIS

Assets that are acquired by gift or by inheritance have a "uniform basis" that is applied to everyone who acquired an interest in the property by gift or inheritance [Treas. Reg. §§1.1015-1(b) and 1.1014-5(a)(1)]. The uniform basis is allocated between the owner of a life interest and the owner of a remainder interest according the relative value of their interests in the property.

Practitioner Note. The life interest and remainder interest could be created by a legal life estate and remainder interest, or by putting the property in a trust that gives the income to one person for life and the trust assets to another person upon the death of the first.

The relative value of the life interest and the remainder interest is determined under I.R.C. §7520 by using tables prescribed by the Secretary of the Treasury. Those tables determine the portion of the value of property that is allocated to the owner of the life interest and to the owner of the remainder interest. The allocation is based on:

1. The life expectancy of the owner of the life interest
2. A discount rate equal to 120% of the midterm applicable federal rate under I.R.C. §1274(d)(1) for the month in which the valuation is made

Example 31. Eunice gave a life interest in undeveloped land to her brother, Sam, and gave the remainder interest to her daughter, Fern, in April 2001. At the time of the gift, Eunice's basis in the land was $100,000. Sam was 55 years old at the time of the gift. The $100,000 becomes the uniform basis of the land for Sam and Fern. It is allocated between them as follows.

First, the appropriate discount rate is determined by finding 120% of the midterm applicable federal rate for April 2001. That rate (rounded to the nearest two-tenths of 1%) is 5.8%.

Second, the ratio of the basis to allocate to Fern's remainder interest is found in Table S of Treas. Reg. §20.2031-7(d)(7) by finding the ratio in the row for age 55 and the column for 5.8%. The portion of that table reproduced below shows that the ratio allocated to Fern's interest is .299918 or 29.918%. Therefore, $29, 918 of the uniform basis is allocated to Fern.

TABLE S. BASED ON LIFE TABLE 90CM
SINGLE LIFE REMAINDER FACTORS
APPLICABLE AFTER APRIL 30, 1999
[INTEREST RATE]

Age	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
53 …	.37550	.36070	.34668	.33339	.32078	.30882	.29746	.28667	.27643	.26669
54 …	.38717	.37237	.35833	.34500	.33234	.32031	.30888	.29801	.28766	.27782
55 …	.39903	.38424	.37019	.35683	.34413	.33205	.32056	.30961	**.29918**	.28925
56 …	.41108	.39631	.38227	.36890	.35617	.34405	.33250	.32149	.31099	.30097
57 …	.42330	.40857	.39455	.38118	.36844	.35629	.34469	.33363	.32306	.31297

Sam's basis in his life interest is the remaining $70,082 ($100,000 – $29,918).

Practitioner Note. As the owner of the life interest gets older, the value of his or her life interest decreases because his or her life expectancy decreases. The value of the remainder interest increases as the value of the life interest decreases. The uniform basis rules require the uniform basis to be shifted from the owner of the life interest to the owner of the remainder interest at the same rate as the value of the life interest decreases and the value of the remainder interest increases.

SALE OF THE UNDERLYING PROPERTY

If the owner of the life interest and the owner of the remainder interest convey their interests to a common buyer, they will each report their share of the gain or loss on the sale. Their share of the gain or loss is computed by subtracting their share of the uniform basis **at the time of the sale** from their share of the sale proceeds.

Example 32. Sam and Fern (from Example 31) sell the land to Jim in 2013 for $240,000 when Sam is 67 years old. They agree to divide the proceeds from the sale equally between them. One-hundred-twenty percent of the midterm applicable federal rate for the month of sale (rounded to the nearest two-tenths of 1%) is 7.0%. Fern's gain is calculated as follows:

Sale proceeds (50% of $240,000)		$120,000
Fern's basis		
Uniform basis	$100,000	
Ratio allocated to Fern (from table below)	× .39941	
Basis allocated to Fern		39,941
Fern's gain		$ 80,059

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TABLE S. BASED ON LIFE TABLE 90CM
SINGLE LIFE REMAINDER FACTORS
APPLICABLE AFTER APRIL 30, 1999
[INTEREST RATE]

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
65 …	.40718	.39761	.38838	.37947	.37087	.36257	.35455	.34681	.33932	.33208
66 …	.42128	.41172	.40249	.39357	.38496	.37663	.36858	.36079	.35326	.34597
67 …	.43569	.42616	.41694	.40803	**.39941**	.39107	.38299	.37518	.36761	.36028
68 …	.45038	.44089	.43170	.42281	.41419	.40585	.39777	.38994	.38235	.37499

TABLE S. BASED ON LIFE TABLE 90CM
SINGLE LIFE REMAINDER FACTORS
APPLICABLE AFTER APRIL 30, 1999
[INTEREST RATE]

69 … .46531	.45587	.44672	.43786	.42927	.42094	.41286	.40503	.39743	.39006

Sam's gain is calculated as follows:

Sale proceeds (50% of $240,000)		$120,000
Sam's basis		
Uniform basis	$100,000	
Less Fern's basis	39,941	
Basis allocated to Sam		60,059
Sam's gain		$ 59,941

Practitioner Note. The owner of the remainder interest is deemed to have acquired that interest when the donor created it, not when the owner of the life interest dies. Therefore, the holding period for the owner of the remainder interest is the donor's holding period before the date of the gift plus the holding period after the date of the gift.

SALE OF A LIFE INTEREST

In the case of life interests created by gift or inheritance (and in transfers between spouses or incident to a divorce), the life interest owner's share of the uniform basis is disregarded if he or she sells the life interest in a transaction that does not include the sale of the remainder interest [I.R.C. §1001(e)]. Consequently, all of the proceeds received on the sale must be reported as gain from the sale.

Example 33. Assume the same facts as in Example 32, except that Fern does not sell her remainder interest to Jim. Jim purchases only Sam's life interest and pays $120,000 for it. Sam must report $120,000 of gain from the sale, because his basis in the life interest is disregarded.

Observation. Jim has a $120,000 basis in the life interest and he can use that basis to offset sale proceeds on a subsequent sale since he did not acquire the life interest by gift, inheritance, or in a transfer between spouses or incident to a divorce.

SALE OF A REMAINDER INTEREST

The rule that disregards basis on sale of a life interest does not apply to the sale of a remainder interest. Consequently, if the owner of a remainder interest sells that interest in a transaction that does not include the sale of the life interest, the remainder interest owner's share of the uniform basis is used to calculate gain or loss on the sale.

Example 34. Assume the same facts as in Example 32 except that Sam does not sell his life interest to Jim. Jim purchases only Fern's remainder interest, and pays $120,000 for it. Fern's gain is $80,059, as shown in Example 32.

DEATH OF OWNER OF REMAINDER INTEREST BEFORE DEATH OF OWNER OF LIFE INTEREST

If the owner of the remainder interest dies before the owner of the life interest, a special rule applies to determine the basis of the remainder interest. Under Treas. Reg. §1.1014-8(a), the basis of the remainder interest in the hands of the person(s) who receive(s) the remainder interest from the decedent is computed by adjusting the uniform basis allocated to the remainder interest by the difference between the value of the remainder interest in the decedent's estate and the uniform basis allocated to the remainder interest at the time of death.

Example 35. Assume that, as in Example 31, Eunice gave a life interest in undeveloped land to her brother, Sam, and gave the remainder interest to her daughter, Fern, in April 2001. At the time of the gift, Eunice's basis in the land was $100,000. Sam was 55 years old at the time of the gift.

Further assume that Sam and Fern still owned their respective interest when Fern died in 2006. Fern's will gave her remainder interest to her son, Pete. At the time of her death, Fern's remainder interest was worth $60,000.

Since Sam was 60 years old at the time of Fern's death and 120% of the midterm federal applicable rate (rounded to the nearest two-tenths of 1%) was 6.4%. The uniform basis allocated to the remainder interest at that time is calculated as follows:

Uniform basis	$100,000
Ratio allocated to Fern's estate (from table below)	× .33107
Basis allocated to Fern's estate	$ 33,107

TABLE S. BASED ON LIFE TABLE 90CM SINGLE LIFE REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1999 [INTEREST RATE]

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
58…	.31551	.30621	.29731	.28878	.28061	.27278	.26528	.25807	.25116	.24453
59 …	.32790	.31854	.30956	.30095	.29269	.28477	.27716	.26986	.26284	.25610
60 …	.34050	**.33107**	.32202	.31334	.30500	.29699	.28929	.28190	.27478	.26794
61 …	.35331	.34384	.33473	.32598	.31757	.30948	.30170	.29422	.28701	.28007
62 …	.36639	.35688	.34772	.33892	.33044	.32229	.31443	.30687	.29958	.29255

However, Pete's basis in the remainder interest at the time he inherited it is its $60,000 fair market value.

Further assume that, as in Example 32, Sam and Pete sell the underlying land to Jim for $240,000 in 2013 when Sam is 67 years old. Sam and Pete agree to divide the sale proceeds equally. Sam's gain is the same as in Example 32. Pete's gain is calculated as follows:

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Sale proceeds (50% of $240,000)			$120,000
Pete's basis			
Uniform basis		$100,000	
Ratio allocated to Pete (from table in Example 32)		× .39941	
Uniform basis allocated to Pete		$ 39,941	
Adjustment			
Value in Fern's estate	$60,000		
Minus uniform basis allocated to the remainder interest at the time Fern's death	33,107		
Adjustment to basis		$ 26,893	
Pete's basis in remainder interest			$ 66,834
Pete's gain on sale			$ 53,166

Observation. The effect of the basis adjustment is to reduce the gain that Pete must recognize by $26,893, which is the difference between the $60,000 fair market value of the remainder interest at the time of Fern's death and the $33,107 uniform basis allocated to the remainder interest at that time. In other words, Pete gets the advantage of the step-up in basis at Fern's death.

ADJUSTMENTS TO UNIFORM BASIS

The uniform basis rules require all the taxpayers who have an interest in the property to adjust the uniform basis up for improvements made by any of the owners of an interest in the property, and down by deductions claimed by any owners of an interest in the property.

Example 36. Wayne gave a life interest in a rental duplex to his sister, Anne, and the remainder interest in the apartment building to his daughter, Susan. Wayne's basis in the duplex was $100,000 at the time of the gift. Since the property was acquired by gift, the uniform basis for Anne and Susan is $100,000. As the owner of the life interest, Anne is allowed to claim all of the depreciation on the duplex. Assuming she is allowed to deduct $7,000 of depreciation in 2001, both Sam and Fern must reduce the uniform basis in the property by $7,000.

DISCLOSING GIFTS ON GIFT TAX RETURNS

The Taxpayer Relief Act of 1997 (TRA of 1997) dramatically changed the effect of filing gift tax returns.

Prior Law. Prior to the TRA of 1997, there was no statute of limitations on the valuation of gifts for purposes of the estate tax calculation. Consequently, upon death of the donor, the IRS could challenge the reported or unreported value of a gift for purposes of including prior gifts in the estate tax calculation.

Example 37. Marshall Law gave 10,000 shares of stock in his closely held company to his daughter, Anne, in 1990. He reported a value of $110,000 for the stock on a timely filed gift tax return for 1990. The annual exclusion reduced the taxable gift to $100,000, and the unified credit available in 1990 offset the tentative tax on the transfer, so there was no gift tax due. Marshall made no other taxable gifts during his life.

Marshall passed away in 2000. His will left his entire $700,000 taxable estate to his daughter, Anne. As personal representative of his estate, Anne filed the following Form 706 showing $29,250 of estate taxes due.

Form **706** (Rev. July 1999)
Department of the Treasury Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see separate instructions).
To be filed for decedents dying after December 31, 1998
For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

OMB No. 1545-0015

Executor

1a Decedent's first name and middle initial (and maiden name, if any)	1b Decedent's last name		2 Decedent's Social Security No.
Marshall	*Law*		*709 13 6501*
3a Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country)	3b Year domicile established	4 Date of birth	5 Date of death

Part 2.—Tax Computation

1	Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12)			1	*760,000*
2	Total allowable deductions (from Part 5, Recapitulation, page 3, item 23)			2	*60,000*
3	Taxable estate (subtract line 2 from line 1)			3	*700,000*
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))			4	*100,000*
5	Add lines 3 and 4			5	*800,000*
6	Tentative tax on the amount on line 5 from Table A on page 12 of the instructions			6	*267,800*
7a	If line 5 exceeds $10,000,000, enter the lesser of line 5 or $17,184,000. If line 5 is $10,000,000 or less, skip lines 7a and 7b and enter -0- on line 7c	7a			
b	Subtract $10,000,000 from line 7a	7b			
c	Enter 5% (.05) of line 7b			7c	*0*
8	Total tentative tax (add lines 6 and 7c)			8	*267,800*
9	Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)			9	*0*
10	Gross estate tax (subtract line 9 from line 8)			10	*267,800*
11	Maximum unified credit (applicable credit amount) against estate tax	11			
12	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 4 of the instructions.)	12			
13	Allowable unified credit (applicable credit amount) (subtract line 12 from line 11)			13	*220,550*
14	Subtract line 13 from line 10 (but do not enter less than zero)			14	*47,250*
15	Credit for state death taxes. Do not enter more than line 14. Figure the credit by using the amount on line 3 less $60,000. See Table B in the instructions and **attach credit evidence** (see instructions)			15	*18,000*
16	Subtract line 15 from line 14			16	*29,250*
17	Credit for Federal gift taxes on pre-1977 gifts (section 2012) (attach computation)	17			
18	Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	18			
19	Credit for tax on prior transfers (from Schedule Q)	19			
20	Total (add lines 17, 18, and 19)			20	*0*
21	Net estate tax (subtract line 20 from line 16)			21	*29,250*
22	Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)			22	*0*
23	Total transfer taxes (add lines 21 and 22)			23	*29,250*
24	Prior payments. Explain in an attached statement	24			
25	United States Treasury bonds redeemed in payment of estate tax	25			
26	Total (add lines 24 and 25)			26	*0*
27	Balance due (or overpayment) (subtract line 26 from line 23)			27	*29,250*

On audit of Marshall's estate tax return, the IRS determined that the value of the stock given to Anne in 1990 was $310,000, rather than $110,000. Therefore, the IRS increased the estate tax due by $78,000 as follows:

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	Originally Reported	Adjustment	Adjusted Amount
1. Total gross estate less exclusion	$760,000	-0-	$ 760,000
2. Total allowable deductions	60,000	-0-	60,000
3. Taxable estate	$700,000	-0-	$ 700,000
4. Adjusted taxable gifts	100,000	$200,000	300,000
5. Add lines 3 and 4	$800,000	$200,000	$1,000,000
6. Tentative tax	$267,800	$ 78,000	$345,800
9. Total gift tax payable	-0-	-0-	-0-
10. Gross estate tax	$267,800	$ 78,000	$ 345,800
13. Allowable unified credit	220,550	-0-	220,550
14. Subtract line 13 from line 10	$ 47,250	$ 78,000	$ 125,250
15. Credit for state death taxes	18,000	-0-	18,000
16. Subtract line 15 from line 14	$ 29,250	$ 78,000	$ 107,250

TRA of 1997. The TRA of 1997 gives taxpayers a statute of limitations for purpose of the estate tax if the statute has run for purposes of the gift tax.

Example 38. Hy Towers gives closely held stock to his daughter, Belle, in 2000, and adequately discloses it as a $100,000 gift on a timely filed gift tax return. The IRS does not challenge the $100,000 valuation. Hy dies in 2010, leaving his $700,000 estate to Belle. The IRS cannot challenge the $100,000 valuation of the stock on Hy's estate tax return.

TRA OF 1997 DISCLOSURE RULES

While the TRA of 1997 disclosure rules were enacted to put a statute of limitations on the valuation of gifts for estate tax purposes, they also have an effect on the gift tax statute of limitations in two respects. First, they increase the reporting requirements for starting the running of the statute of limitations. Second, they apply the statute of limitations not only to the valuation of the gift, but also to the application of the gift tax rules to the gift tax computation. In other words, they impose a **higher burden** for starting the statute of limitations but give the taxpayer **greater protection** if the statute has run.

There are two separate but related gift tax calculations that are affected by the new disclosure rules. One is calculation of gift taxes due in the year of the gift. A second is the calculation of gift taxes in a later year, when the gift is included as a prior-year gift.

Gift taxes in the year of the gift. Under prior law, the three-year statute of limitations began to run on the gift tax liability of a taxpayer if the taxpayer filed a gift tax return for the year of the gift. Therefore, if a taxpayer filed a gift tax return but omitted a gift from the return, the IRS could not assess a gift tax on the omitted gift after the period ending three years after the gift tax return was filed.

> **Practitioner Note.** Under prior law, if unreported gifts exceeded 25% of the gifts reported on the gift tax return, the statute of limitations was six years rather than three years.

Example 39. In 1994, Hugh Midd gave $400,000 of publicly traded stock to his daughter. He also sold 10% of his business to his son for $100,000. Hugh filed a gift tax return before April 15, 1995, and reported the $400,000 gift to his daughter. There was no gift tax due as a result of the unified credit that was available in 1994. He did not report the sale of the 10% interest in his business because he believed the value of the interest was $100,000 and there was no gift.

After April 15, 1998 (three years after the due date of the 1994 gift tax return), the IRS cannot impose additional gift taxes on Hugh even if the IRS can prove the value of the 10% interest in his business is more than $200,000, since the unreported gift ($200,000 – $100,000 = $100,000) is not more than 25% of the $400,000 reported gifts. After April 15, 2001 (six years after the due date of the 1994 gift tax return), the IRS cannot impose additional gift taxes on Hugh regardless of the value it can prove for the 10% interest in his business.

Practitioner Note. Under prior law, a gift tax return that was not required to be filed apparently did not start the statute of limitations. For example, if a donor's only gift was a gift of $9,000, reporting it on a gift tax return did not start the statute of limitations because such gifts did not trigger the filing requirement. Under the TRA of 1997 rules, filing a gift tax return even when it is not required will start the statute if the adequate disclosure requirements are met.

Under the TRA pf 1997, the statute of limitations does not run for a gift unless that gift is adequately disclosed on a gift tax return or otherwise meets the disclosure requirements.

Example 40. Assume the same facts as in Example 39, except that Hugh made his gift to his daughter and sold the 10% interest in his business to his son in 2000. If Hugh does not adequately disclose the transfer of the interest in his business to his son on a gift tax return, the IRS can assess gift taxes for that transfer at any time.

A transfer to a family member in the ordinary course of business is adequately disclosed if both parties report the transaction on a their income tax returns. It does not have to be reported on a gift tax return.

Example 41. If Hugh paid his son a salary for working in the business, the statute of limitations begins to run for gift tax purposes on that transfer if Hugh shows the salary as a deduction on his income tax return and his son reports it as income on his return.

Practitioner Note. Reporting a **transfer of an interest in a business** on an income tax return is not adequate disclosure, since that transfer is not in the ordinary course of business.

Gift taxes for year after the gift. A gift affects the calculation of gift taxes in a subsequent year because all prior taxable gifts are a part of the gift tax calculation. However, under prior law, a different rule applied for starting the statute of limitations with respect to valuing the gift for the subsequent year calculation. The IRS could revalue a prior gift unless a gift tax was paid or assessed for the year of the gift, **and** the time had expired for assessing a gift tax for the year of the gift.

Example 42. Assume the same facts as in Example 39 (gift to daughter and sale to son in 1994) and in addition, assume that Hugh gave $400,000 of publicly traded stock to his son in 2000. Since Hugh did not owe any gift tax for his 1994 gift to his daughter, the IRS can revalue his gift to his daughter and revalue the transfer of the 10% interest in his business to his son at any time for purposes of including the gifts in a subsequent year gift tax calculation. Assuming the IRS can prove the value of the 10% interest in the business was $200,000, the gift taxes for 2000 before and after the revaluation of the 1994 transfer are shown below.

	Before Revaluation	After Revaluation
Taxable gift in 2000	$390,000	$390,000
Prior taxable gifts	390,000	480,000
Total taxable gifts	$780,000	$870,000
Tentative tax	$260,000	$295,100
Less applicable credit amount	220,550	220,550
Gift taxes due	$ 39,450	$ 74,550

Under the TRA of 1997 rules, if the statute of limitation has run for purposes of the gift tax liability in the year of the gift, it has also run for purposes of the gift tax liability in a subsequent year.

Example 43. Assume the same facts as in Example 40 (gift to daughter and sale to son in 2000) and in addition, assume that Hugh gave $400,000 of publicly traded stock to his son in 2006. If Hugh adequately discloses the transfer of the 10% interest in his business on his 2000 gift tax return, the statute of limitations on challenging the value of that transfer runs for purposes of gift taxes for later years as well as for gift taxes in 2000. Therefore, the IRS could not challenge the value of the 2000 transfer as a prior gift in the 2006 gift tax calculation.

Omitted Gifts. If a gift is inadvertently omitted from a previously filed gift tax return, an amended gift tax return for the year in which the gift was made must be filed with the same Service Center where the prior gift tax return was filed. On the top of the first page of the amended return, write the words "Amended Form 709 for gift(s) made in (calendar year that the gift was made)." The return must identify the transfer and provide all information required under the disclosure rules. If this procedure is followed, the statute of limitations will begin running on the omitted gift.

DISCLOSURE REQUIREMENTS

A transfer is adequately disclosed on a gift tax return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value that is reported. Transfers reported on the gift tax return as transfers of property by gift are adequately disclosed if the return (or a statement attached to the return) provides the following information:

1. A description of the transferred property and any consideration received by the transfer or

   - For real estate, provide:
     a. A legal description of each parcel
     b. The street number, name and area if the property is located in a city
     c. A short description of any improvements to the property
   - For bonds, give:
     a. The number of bonds transferred
     b. The principal amount of each bond
     c. Name of obligor
     d. Date of maturity
     e. Rate of interest
     f. Date or dates when interest is payable
     g. Series number if there is more than one issue
     h. Exchanges where listed or, if unlisted, give the location of the principal business office of the corporation
     i. CUSIP number

- For stocks:
  - **a.** Give number of shares
  - **b.** State whether common or preferred
  - **c.** If preferred, give the issue, par value, and exact name of corporation
  - **d.** If listed on a principal exchange, give location of principal business office of corporation, state in which incorporated, and date of incorporation
  - **e.** If listed, give principal exchange
  - **f.** CUSIP number
- For interests in property based on the length of a person's life:
  - **a.** Give the person's date of birth
- For life insurance policies:
  - **a.** Give the name of the insurer and the policy number

2. The identity of, and relationship between, the donor and each donee

3. If the property is transferred in trust:

- **a.** The trust's tax identification number and a brief description of the terms of the trust, (or in lieu of a brief description of the trust terms) A copy of the trust instrument

4. Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift:

- **a.** Including any financial data (for example, balance sheets, with explanations of any adjustments) that were utilized in determining the value of the interest
- **b.** Any restrictions on the transferred property that were considered in determining the fair market value of the property
- **c.** A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property

5. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis:

- **a.** Including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements

6. In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded:

- **a.** A description of any discount claimed in valuing the interests in the entity or any assets owned by such entity must be provided
- **b.** In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity)
- **c.** The pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return
- **d.** If 100% of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity
- **e.** If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required must be

provided for each entity, if the information is relevant and material in determining the value of the interest

7. 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 (see Treas. Reg. §601.601(d)(2) of this chapter).
8. Statement of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued. The appraisal is prepared by an appraiser who satisfies all of the following requirements:
   a. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis
   b. The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee
   c. The appraiser is not any person employed by the donor, the donee, or a member of the family of either

9. The appraisal contains all of the following:
   a. The date of the transfer
   b. The date on which the transferred property was appraised, and the purpose of the appraisal
   c. A description of the property
   d. A description of the appraisal process employed
   e. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions
   f. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value
   g. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions
   h. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred
   i. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

The following examples illustrate the disclosure rules:

Example 44: Transfer of stock adequately disclosed. In 2001, Ace transfers 100 shares of common stock of XYZ Corporation to Ace's child. The common stock of XYZ Corporation is actively traded on a major stock exchange. For gift tax purposes, the fair market value of one share of XYZ common stock on the date of the transfer is $150.00. Ace reports the gift to Ace's child of 100 shares of common stock of XYZ Corporation with a value for gift tax purposes of $15,000. Ace specifies the date of the transfer, recites that the stock is publicly traded, identifies the stock exchange on which the stock is traded, lists the stock's CUSIP number, and lists the mean between the highest and lowest quoted selling prices for the date of transfer. Ace has adequately disclosed the transfer.

Example 45: Transfer of closely held stock adequately disclosed. Ace owns 100% of the common stock of X, a closely held corporation. X does not hold an interest in any other entity that is not actively traded. In 2001, Ace transfers 20% of the X stock to Barb and Carl, Ace's children. The transfer is made outright with no restrictions on ownership rights, including voting rights and the right to transfer the stock. Based on generally applicable valuation principles, the value of X would be determined based on the net value of the assets owned by X. The reported value of the transferred stock incorporates the use of minority discounts and lack of marketability discounts. No other discounts were used in arriving at the fair market value of the transferred stock or any assets owned by X. Ace provides the information required—a statement reporting the fair market value of 100% of X (before taking into account any discounts), the pro rata portion of X subject to the transfer, and the reported value of the transfer. Ace also attaches a statement regarding the determination of value, that includes a discussion of the discounts claimed and how the discounts were determined. Ace has provided sufficient information such that the transfer will be considered adequately disclosed, and the period of assessment for the transfer will run from the time the return is filed.

Example 46: Transfer of interest LLP not adequately disclosed. Ace owns a 70% limited partnership interest in PS. PS owns 40% of the stock in X, a closely held corporation. The assets of X include a 50% general partnership interest in PB. PB owns an interest in commercial real property. None of the entities (PS, X, or PB) is actively traded and, based on generally applicable valuation principles, the value of each entity would be determined based on the net value of the assets owned by each entity. In 2001, Ace transfers a 25% limited partnership interest in PS to Barb, Ace's child. On the federal gift tax return, Ace reports the transfer of the 25% limited partnership interest in PS and that the fair market value of 100 percent of PS is $*y* and that the value of 25% of PS is $*z*, reflecting marketability and minority discounts with respect to the 25% interest. However, Ace does not disclose that PS owns 40% of X, and that X owns 50% of PB and that, in arriving at the $*y* fair market value of 100% of PS, discounts were claimed in valuing PS's interest in X, X's interest in PB, and PB's interest in the commercial real property.

The information on the lower-tiered entities is relevant and material in determining the value of the transferred interest in PS. Accordingly, because Ace has failed to comply with disclosure requirements regarding PS's interest in X, X's interest in PB, and PB's interest in the commercial real property, the transfer will not be considered adequately disclosed, and the period of assessment for the transfer will remain open indefinitely.

Example 47: Transfer of interest in LLP adequately disclosed. The facts are the same as in Example 46 except that Ace submits, with the federal tax return, an appraisal of the 25% limited partnership interest in PS that satisfies the disclosure requirements. Assuming the other disclosure requirements are satisfied, the transfer is considered adequately disclosed and the period for assessment for the transfer will run from the time the return is filed.

Example 48: Transfer of property to related parties adequately disclosed. Ace owns 100% of the stock of X Corporation, a company actively engaged in a manufacturing business. Barb, Ace's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. Barb reports the annual salary as income on her income tax returns. In 2001, Ace transfers property to family members and files a Federal gift tax return reporting the transfers. However, Ace does not disclose the 2001 salary payments made to Barb. Because the salary payments were reported as income on Barb's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to Barb, reported on the gift tax return must satisfy the adequate disclosure in order for the period of assessment to commence to run with respect to those transfers.

EFFECTIVE DATES

The new rules have effective dates for purposes of calculating current gift taxes on the gift that differ from those for purposes of calculating gift taxes for subsequent years and estate taxes.

Current year gift taxes. For purposes of calculating current gift taxes, the new rules are effective for gifts made after December 31, 1996, for which a gift tax return is filed after December 3, 1999.

Gift taxes for subsequent years and estate taxes. For purposes of calculating gift taxes in a year after the gift and for purposes of calculating estate taxes upon death of the donor, the new rules are effective for gifts made after August 5, 1997, if the gift tax return for year of the gift is filed after December 3, 1999.

The new regulations under I.R.C. §2504 give the following example [Treas. Reg. §25.2504-2(c) Example 3].

Example 49. In 1994, A transferred closely held stock to B and C, A's children. A timely filed a Federal gift tax return reporting the 1994 transfers to B and C, and paid gift tax on the value of the gifts reported on the return. Also in 1994, A transferred closely held stock to B in exchange for a bona fide promissory note signed by B. A believed that the transfer to B in exchange for the promissory note was for full and adequate consideration and A did not report that transfer to B on the 1994 Federal gift tax return. In 2002, A transfers additional property to B and timely files a federal gift tax return reporting the gift.

Under I.R.C. §2504(c), in determining A's 2002 gift tax liability, the value of A's 1994 gifts cannot be adjusted for purposes of computing prior taxable gifts because those gifts were made prior to August 6, 1997, and a timely filed federal gift tax return was filed with respect to which a gift tax was assessed and paid, and the period of limitations on assessment has expired. The provisions of paragraph (a) of this section apply to the 1994 transfers. However, for purposes of determining A's adjusted taxable gifts in computing A's estate tax liability, the gifts may be adjusted [See Treas. Reg. §20.2001-1(a)].

FILING DEADLINE

Gift tax returns are due by April 15 of the year following the calendar year in which the gift was made. If the donor has been given an extension to file his or her income tax return for the calendar year of the gift, the date for filing the gift tax return is extended to the same date. There is no penalty for filing a gift tax return late if there is no gift tax due other than the delay in starting the statute of limitations.

Example 50. Malcolm Tente gave 1,000 units of his Limited Liability Company (LLC) to his daughter in 1997. Malcolm valued the 1,000 units at $200,000. As a tax protester, he has not filed income or gift tax returns for several years. Malcolm went to see a tax preparer in 2000 and asked about the consequences of filing a gift tax return for the 1997 gift.

One effect of filing a gift tax return in 2000 for the 1997 gift is that it will start the 3-year statute of limitations running as of the date of filing the return. If the return had been filed by the April 15, 1998, due date, the statute would have expired on April 15, 2001.

> **Observation.** Many gifts trigger the gift tax return filing requirement without triggering any gift tax liability because the applicable credit amount ($220,550 in 2000) offsets the gift tax liability.

There is a penalty for a late payment of gift taxes. If the gift tax return is filed late, there is a penalty based on the gift taxes due on the return reduced by any gift taxes that were paid on time.

The penalty for a late payment of gift tax is the same as the penalty for late payment of income taxes. It is 0.5% of the taxes due for each month or portion of a month the taxes are paid late, up to a maximum of 25%.

The penalty for filing a gift tax return late is the same as the penalty for filing an income tax return late. It is 5% of the taxes due for each month or portion of a month the return is filed late, up to a maximum of 25%.

Example 51. Sally Forth gave $700,000 of stocks and bonds to her two children in 1999. She asked her income tax preparer to get an extension for filing her income tax return for 1999. Sally did not tell her preparer about the gifts until she took her records to him in June 2000. Her preparer filed a Form 709 on June 20, 2000, showing the $700,000 gift and a $1,850 gift tax due.

There is no penalty for the late-filed gift tax return because the due date of Sally's income tax return was extended to August 15, 2000. There is a penalty for the late payment of gift taxes. It is 3 months × 0.5% × $1,850 = $27.75. Sally must also pay interest on the late payment of gift taxes.