Willard J. De Filipps, CPA, PC
www.defilipps.com
A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. INDEX OF ALL ARTICLES IN *DEALER TAX WATCH* FROM 1994-1999 IS NOW AVAILABLE. We have compiled an index of all articles in the *Dealer Tax Watch* from our first issue (June, 1994) through December, 1999. This *Index of Articles* has seven sections. In addition to listing all articles by subject, there are *Finding Lists* for all tax cases, IRS Coordinated Issue Papers, Field Service Advice Memoranda, Letter Rulings (including TAMs), Revenue Rulings, Revenue Procedures and the *Practice Guides* included with various articles.

The easiest way to obtain a copy of the entire *Index of Articles* is to request by phone, fax or e-mail that the Word™ document be sent via e-mail to you. Or, we can send you a copy by fax or U.S. mail immediately. As always, we appreciate any comments or constructive criticism you may have. See pages 29-31 for an idea of what this index is like.

#2. WHAT ARE AUTO DEALERS BIGGEST CONCERNS? Obviously, the answer will depend on whom you ask. However, it appears that dealers have different concerns depending on what makes they're selling and against whom they're competing. At the NADA Convention earlier this year, dealers attending their make meetings in Orlando voiced their concerns, and you might be interested in the summary of what they said which begins on page 9.

#3. SERVICE TECHNICIAN TOOL RENTAL & REIMBURSEMENT PLANS. Two developments have occurred since our last Update on tool rental plans. Two things are clear from them. First, the IRS is now also looking more carefully at the special "anti-abuse" provisions of the regulations under Section 62(c). Second, the requirement that the plan must have a true business connection is far more difficult to comply with than some may have previously thought.

WATCHING OUT FOR

In ILM 200006005, the IRS rejected an auto dealer's plan because it failed to meet the "business connection" requirement. (Dealers Beware!)

In a case involving a delivery business and the interpretation of the same accountable plan rules to its "reimbursement" payments, the United States District Court, Northern District of California, upheld the IRS' strict interpretation of the "business connection" requirement. The Court also imposed penalties on the

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delivery courier service even though it tried to argue that it had relied on its accountant for advice in connection with setting up the plan. Over $450,000 in Federal employment taxes, interest and penalties were assessed in the *Shotgun Delivery* case.

Both of these developments mean growing trouble for dealers who already have implemented special technician "accountable" pay plans. How will the IRS act in fulfilling its mission to administer the laws impartially and uniformly with countless plans already in existence out there, now that these precedents are starting to pile up? For more, see page 6.

#4. CAN DEALERS USE REPLACEMENT COST FOR VALUING PARTS INVENTORIES? We have been closely following the *Mountain State Ford Truck Sales (MSFTS)* decision which is the flashpoint for the replacement cost dilemma. In *MSFTS*, the Tax Court agreed with the IRS that the dealer could not use replacement cost instead of actual cost in valuing its parts inventories.

Therefore, we know that according to the IRS and the Tax Court, dealers have to use AC (actual cost) and not RC (replacement cost) for valuing their parts inventories.

Briefly, here are the latest developments. First, *Mountain State Ford* has appealed the Tax Court's decision to the U.S. Court of Appeals for the Tenth Circuit in Denver.

Second (but really ahead of *MSFTS* if any kind of time-line can be laid over things like this) is the fact that another taxpayer, Consolidated Manufacturing, Inc., has also filed an appeal to the 10th Circuit over the Tax Court's decision by the same judge in its own case.

Many parallels exist with the *MSFTS*-parts replacement cost issue because in *Consolidated Manufacturing, Inc.*, the IRS and the Tax Court upset another industry-wide practice which had some 40 years of acceptance behind it. How the *MSFTS*-replacement cost issue will be resolved by the Appeals Court is clearly impacted by the fact that the same Appeals Court will be hearing the appeal of *Consolidated Manufacturing, Inc.*, ahead of the *MSFTS* appeal. Beyond that, as to when–and how–the Appeals Court will rule is anybody's guess. But, if you're the IRS, you can't help but liking your odds.

In the meantime, NADA has submitted a series of proposals for consideration by the IRS. These are compromise methods which would permit an actual cost-mutation (i.e., a reasonable approximation or estimation) based on a rather general and unstratified computation of the estimated overall inventory turn.

(Continued from page 1)

It appears the IRS has not completely rejected these proposals out-of-hand. After all, even the IRS by now knows that there is no way to compute actual cost for a parts inventory.

#5. DEALERS CAN'T TAKE FAST WRITE-OFFS FOR VSC PREMIUMS PAID. In a recent Tax Court case involving over half-a-dozen dealerships, the issue was whether the dealerships (who were primarily obligors) could take accelerated deductions for insurance premiums incurred in connection with extended warranty contract sales. The IRS said those insurance premium expenditures were required to be amortized more slowly and ratably over the years covered by the vehicle service warranty.

The Court held that the IRS was correct in requiring ratable amortization of the insurance premiums. This case involved taxable years which bridged the introduction of Revenue Procedures 92-97 and 92-98 and the Service Warranty Income Method (SWIM).

In *Toyota Town, Inc.* (T.C. Memo 2000-40; Feb. 8, 2000), the Court held that a dealer can't expect to have it both ways. It can't expect the benefit of a tax deferral under the SWIM method and at the same time accelerate deductions of the write-off of the cost of the insurance premium paid to protect itself against loss on those policies. This case will be analyzed in the next issue of the *Dealer Tax Watch*.

#6. FINAL REGULATIONS REQUIRE ADEQUATE DISCLOSURE TO PREVENT THE IRS FROM REVALUING PREVIOUS GIFTS. CPAs involved with helping their dealer clients with business succession and estate planning need to be aware of some regulations that were recently finalized. These regulations coordinate changes made in the law in 1997 and 1998 concerning how much detail should be disclosed in gift tax returns in order to start the running of the statute of limitations.

The final Regulations now provide the standards for ***adequate disclosure.*** Unless gifts are ***adequately disclosed*** in the gift tax return filed, the IRS literally can come in at any time to assess additional tax, reduce available unified credit amounts and/or revalue prior gifts for estate and/or gift tax purposes. The IRS can do this even as late as when the donor dies many years later and his estate tax return is filed.

The Regulations contain some surprises for practitioners who would like to keep a low profile on certain valuation issues and still have their clients enjoy the benefit of protection by the running of the statute of limitations. That simply can't and won't happen.

In addition, the proper treatment of what might be questionable transfers between family members and

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(Continued from page 2)

their closely-held business–*non-gift transfers and transactions*–is also discussed.

The article beginning on page 12 covers all this. In addition, it offers some suggestions for dealing with the new rules.

After reflecting on this article, you may find that you need to now go back and file supplemental (amended?) gift tax returns for 1997, 1998 and possibly even 1999...that is, if you and your client want to sleep better at night.

#7. USED CAR SPECIALIST REPORTS: 1999 TAX ACT HAS CREATED CONFUSION FOR USED CAR DEALERS. Ken Shilson has been frequently mentioned in this publication as a used car and buy-here, pay-here specialist with a nation-wide practice. He recently reported that he has received many calls from dealers and accountants confused about one of the changes made by the Tax Relief Extension Act of 1999. This change prevents taxpayers from using the installment method for reporting the gain on certain asset dispositions.

Some callers mistakenly interpreted this change to include motor vehicle sales under retail sales contracts. This interpretation, of course, is not correct. Used car dealers are currently required to pay the entire tax on profit from the sale of motor vehicles under retail sales contracts in the year of sale if they are reporting on the accrual method. This requirement has existed for more than ten years and was not changed by the new law.

The change in the law now prohibits the use of the installment method (by accrual basis taxpayers) in connection with the sale of businesses and other transactions involving major property dispositions.

Mr. Shilson indicated that under pre-1999 Act Law, the installment method was sometimes used by accrual basis taxpayers to defer the gains on the sale of businesses, and other asset dispositions like real estate. The installment method also allowed taxpayers to defer the gain on these sales even though, under the accrual method, income is generally taxable as soon as events have occurred that fix the right to receive such income and such amounts are determinable. The new law now requires dealers using the accrual method who sell their entire dealership to pay the tax on any gain in the year of sale, even if a portion of the purchase price will be paid in future installments.

This new limitation significantly reduces the value to the seller on the sale of a closely-held business. Not surprisingly, this provision in the 1999 Act has been very controversial, and legislation to repeal it is currently under consideration.

If you have questions on how this change affects used car dealers and others in related financing industries, you can call Mr. Shilson at (713) 290-8171 or contact him via his web site at www.kenshilson.com.

#8. FORM 3115 CHANGE REQUESTS DON'T FALL BETWEEN THE CRACKS. We're not aware of many things that go on behind the scenes at the IRS. Two recent ILMs (IRS Legal Memorandums) illustrate one such behind-the-scenes activity. When a taxpayer requests permission to change an accounting method by filing Form 3115 with the National Office, if the IRS denies the request or if the taxpayer withdraws the request (to avoid an adverse ruling), the District Director is routinely notified or alerted to that fact.

Rev. Proc. 99-1 provides: "Request to change an accounting method...If a taxpayer withdraws or the National Office declines to grant (for any reason) a request to change from or to adopt an improper method of accounting, the National Office will notify, by memorandum, the appropriate District Director *and* the Change in Method Issue Specialist, and may give its views on the issues in the request to the appropriate District Director to consider in any later examination of the return." (Section 8.07(2)(a)).

In ILM 200003024 (dated October 22, 1999), the taxpayer withdrew the request for a change in accounting method because of "the long delay in processing the Form 3115." The ILM states that at the time the taxpayer withdrew its request for change "we had not formed a tentative position on taxpayer's proposed change ... However, ... we had advised taxpayer's authorized representative by letter that we had concerns about whether these corrections are a change in method of accounting under Section 446(e) ..."

In contrast to the withdrawal situation, in ILM 199952010, the taxpayer's request for permission to change was denied. Both ILMs were addressed to the respective *District Director: Attention Chief, Examination Division* where the taxpayer filed its return. You can draw your own conclusions about what the District Director may do with this information.

#9. WARNING ON EXPENSING SMALL-DOLLAR EQUIPMENT PURCHASES. The ILM 199952010 mentioned above involved a taxpayer who requested permission from the IRS to write-off all equipment purchases below a selected dollar amount. The Service rejected the notion outright. See *There's No Such Thing as an Expenditure Too Small to Capitalize* on page 5.

It is instructive to consider this ILM in light of many auto dealer checklists which suggest that dealers should forget about capitalizing so-called "small-dollar" purchases.

THERE'S NO SUCH THING ... AS AN EXPENDITURE *TOO SMALL* TO CAPITALIZE
THE IRS SAYS <u>*ALL*</u> EXPENDITURES SHOULD BE CAPITALIZED

ILM 199952010 recently came to light after a long delay in the IRS pipeline. The letter from the IRS denying the taxpayer's request was dated September 29, 1999. It says that it is in response to a Form 3115, Application for Change in Accounting Method, dated September 26, 1991–only 8 years earlier.

Since the National Office denied the taxpayer's request for permission to change methods, notification of that denial was made to the District Director in which the applicant taxpayer filed its tax return. (See *Update* item #8.)

The taxpayer's request was for permission to change its accounting method in connection with capitalizing expenditures for machinery, equipment, furniture and fixture. Under the method it was using, the taxpayer was not capitalizing and depreciating such assets if they cost $1,000 or less. It was expensing the cost of any item if it cost $1,000 or less. The taxpayer requested permission to be allowed to change its method of accounting by increasing this minimum amount from $1,000 to $2,000.

The IRS denied the taxpayer's request. Here's what it said:

> "The taxpayer's current method of not capitalizing assets valued at a certain amount or less ***is not an acceptable method of accounting.*** All property used in a trade or business, other than land or inventory, that has a useful life of more than one year must be capitalized and depreciated. ***Taxpayers are not permitted to treat such items as current expenses simply because the particular item has a certain minimum value or less.***"

Some year-end checklists advise establishing a minimum dollar amount as the cut-off point below which expenditures for fixed assets should be expensed–rather than capitalized. This is often justified as a practical matter to simplify fixed asset recordkeeping.

This ILM serves as a reminder that, as a matter of law, the IRS does not have to accept any arbitrary or *de minimis* cut-off amount.

Even more basic than that, some may not even be aware that if they are following the practice of writing off small-dollar equipment purchases, increasing or lowering that limit would be a change in accounting method. Under Section 446, such a change cannot be made without filing Form 3115 in accordance with Revenue Procedure 98-60.

AUTO DEALER TECHNICIAN TOOL RENTAL PLAN GETS HAMMERED BY THE IRS... WHILE *SHOTGUN DELIVERY'S* PLAN IS SHOT FULL OF HOLES IN COURT

TOOL PLAN UPDATE PART 3

Last quarter, we included *Update–Part 2* in the continuing saga of how the IRS is viewing, or may view, technician tool rental and reimbursement plans offered by third party administrators.

In that article, we referred to Field Service Advice 199940002 which involved _rig rentals_. In that FSA, the IRS concluded that "whether _rig rentals_ are wages depends on whether the rentals are paid pursuant to an accountable plan...Thus, the issue that must be resolved based upon facts and circumstances of each case is whether the _rig rentals_ are paid pursuant to an accountable plan."

We also reported that the National Office was considering a proposed Coordinated Issues Paper (CIP) involving Section 62(c) accountable plan issues and that there might be another CIP that would address the rental issues associated with some of the plans.

This *Update–Part 3* reports two new developments. The first is IRS Legal Memorandum (ILM) 200006005 which is auto dealer-specific...and it is also unfavorable. The second is a District Court case involving the reimbursement arrangement of a delivery business which the Court did not view as falling within the accountable plan rules of Section 62(c). In short, *Shotgun Delivery, Inc.'s* plan was shot down by both the IRS and the District Court.

IRS LEGAL MEMO 200006005

In February, the IRS released ILM 200006005 which is dated August 5, 1999. In this ILM, the Service found that a tool rental arrangement proposed by a dealer did not qualify as an accountable plan under Section 62(c).

The plan submitted never even got to first base, using a baseball analogy with first, second and third base as the equivalent of the three requirements that a reimbursement plan must satisfy to be treated as an accountable plan under Section 62(c). The three requirements (or bases) are:

3 RQMTS

- Legitimate business connection,
- Substantiation, and
- Return of any amounts paid that are in excess of actual expenses incurred.

In this case, an individual intended to construct an automotive repair facility that he would operate as a sole proprietorship. The taxpayer indicated that he planned to hire two automotive technicians as employees of the automotive repair facility. As a condition of employment, each technician would be required to provide his or her own tools with which to perform repair services.

The technicians to be employed would be compensated with two paychecks: One paycheck would be for approximately 65% of the total hourly wage and that payment would be treated as wages subject to Federal Employment Taxes and reported on Form W-2 as wages. The second paycheck for roughly 35% of the total amount would be intended to reimburse the employee for the use of the employee's tools, and that amount would not be reported to the employee as wages on Form W-2. (Within the vernacular of the IRS, this type of compensation plan that allegedly reimburses employees for the use of tools is described as a "tool *rental*" arrangement.)

The individual who submitted the request for ruling withdrew it after he was advised that the IRS would issue an adverse opinion on the proposed plan. Notwithstanding his withdrawal, the District Director was notified that the individual had submitted and subsequently withdrawn a request for a Letter Ruling after being advised of the adverse position the IRS would take.

The taxpayer had represented that tool rental arrangements were common in the automotive industry. (Note: This representation is questionable, and if it is true, the IRS certainly has its work cut out for it.)

The taxpayer had also asserted that such arrangement would be financially more beneficial under the circumstances than would be an arrangement which compensated the two employees without providing for rental of their tools. The individual (dealer) indicated that the tool arrangement was preferable because it would cost the automotive repair facility more to purchase or rent similar tools. This preference was based upon an alleged determination of the tool rental amount which took into consideration various factors including: (1) the hourly rate that the employees would have to be paid without tools, (2) the replacement cost value of the employees' tools and (3) the expenses that the automotive repair facility would incur if it had to rent the same tools from a third party. →

The taxpayer wanted the IRS to rule that the tool rental payments would be under an accountable plan and, as such, would not be subject to Federal Employment Taxes nor reportable on Forms W-2.

"ACCOUNTABLE PLAN" REQUIREMENTS

Previous articles in this series on technician tool plans have discussed in more detail the three requirements for accountable plan treatment that must be met under Section 62(c).

If an employer's arrangement meets all three of the requirements, then all payments made under that arrangement are treated as paid under an accountable plan. Accordingly, the employer can exclude the reimbursements from the employee's income and treat those payments as not being subject to Federal Employment Taxes. However, if amounts are paid under a ***non***accountable plan, those amounts (1) must be included in the employee's gross income, (2) must be reported on Form W-2 and (3) are subject to withholding and to the payment of Employment Taxes by the employer.

If any one of the three requirements is not satisfied, then all amounts paid under the arrangement are treated as paid under a ***non***accountable plan.

WHY THE IRS SAID NO

The IRS found it necessary to analyze only the first requirement under Section 62(c), i.e., the requirement of "business connection."

The *business connection* requirement will not be met if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur the accountable plan business expenses. The language of Code Section 62(a)(2)(A) allows such favorable treatment only for certain reimbursements, namely those expenses which are paid or incurred by the taxpayer in connection with the performance by him of services as an employee under a reimbursement or other expense allowance arrangement with his employer.

The IRS noted that although the taxpayer raised various arguments in his submissions, those arguments failed to address "with specificity" how the tool rentals would satisfy the accountable plan requirements. The Service noted that under the proposed arrangement, the automotive repair facility would employ only employees who have their own tools and that it would pay them an hourly amount for tool rental and that the hourly amount paid for the tool rental ***"bears no relationship to the expenses the employee incurs related to the tools."***

The ILM states: "In fact, (the individual employer) will pay an employee the tool rental, regardless of whether the employee incurred expenses related to those tools while an employee of the automotive repair facility." The ILM concludes, "That does not satisfy the business connection requirement" in Regulation Section 1.62-2(d)(3) because the employer will pay the tool rental regardless of whether the employee is reasonably expected to incur a deductible business expense or other bona fide expense.

One cannot help but conclude from this that the IRS will look very closely at the actual mechanics of how the initial hourly rental amount will be determined. The Service will also look at whether there will be continuous monitoring of that hourly rate over a period of time to determine that it continues to be directly related to the actual use of the tools provided.

During the taxpayer's Conference of Right (after being advised that the Service was anticipating a negative ruling), he took the position that "it was not necessary that the employee actually incur an expense." The Service disagreed with that because Section 62(a)(2)(A) requires otherwise.

"ANTI-ABUSE" CONSIDERATIONS

In the *Law and Analysis* section of the ILM, the Service mentioned the "anti-abuse" language in Reg. Sec. 1.62-2(k). This provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of Section 62(c), then all payments made under the arrangement will be treated as made under a ***non***accountable plan.

The ILM concluded that the arrangement proposed by the taxpayer was one "evidencing a pattern of abuse" of the rules of Section 62(c). The Service said, "***The arrangement*** attempts to recharacterize compensation as reimbursements made from an accountable plan and ***is nothing more than X's attempt to avoid payment of Federal Employment Taxes***." As a result of disqualifying the plan because it never got to first base, the Service found it unnecessary to discuss whether the second and third tests (involving substantiation and the return of excess payments) were satisfied.

SHOTGUN DELIVERY, INC. SHOT DOWN IN COURT

On January 20, 2000, the case of *Shotgun Delivery, Inc. v. USA* was decided against the taxpayer and in favor of the IRS in the United States District Court, Northern District of California. This case involved an IRS assessment of $450,000 of back employment taxes, interest and penalties in connection with a plan that Shotgun Delivery, Inc. had established with its drivers. Shotgun had anticipated that the payments

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under the plan would qualify for the favorable Section 62(c) "accountable" plan treatment.

Shotgun Delivery is a California corporation engaged in the business of providing courier services for point-to-point deliveries. The drivers it employed generally used their own vehicles to make pick-ups and deliveries. These drivers would notify their employer of when they were available to work, and they would then be dispatched by radio to pick up and deliver packages on an as-needed basis.

Much of the discussion in *Shotgun Delivery, Inc.* reads just like ILM 200006005 discussed above and the other ILMs and FSAs in previous *Dealer Tax Watch* articles.

Senior District Judge Samuel Conti found that Shotgun's plan failed to satisfy the first business connection test under Section 62(c). In other words, Shotgun's plan also failed to get to first base. The Court noted that Shotgun's reimbursement arrangement "was in fact, reimbursing its drivers in a manner ***not correlated to expenses*** Shotgun's employees incurred or were reasonably expected to incur."

Accordingly, these expense reimbursements paid by Shotgun did not meet the business connection requirement and were held to be paid pursuant to a ***non***accountable plan. Thus, these payments were subject to full treatment as W-2 wages subject to withholding and the payment by the employer of Employment Taxes.

THE COURT WENT FURTHER

The Court recognized that, due to its holding that Shotgun had not met the business requirement, it was not necessary for it to go any further in its analysis of the other two requirements for an accountable plan. Then the Court added: "That fact notwithstanding, it should be noted that regarding the substantiation requirement, at the end of every pay period, Shotgun drivers did submit reports detailing the hours worked and miles driven each day, which would ostensibly be sufficient to meet the second requirement of an accountable plan. However, Shotgun did not fulfill the ***returning amounts in excess*** requirement."

The Court noted, "It is clear that regardless of any effort made to prevent reimbursement above the allowable per-mile rate, such excess reimbursements were in fact made," and "...Despite this fact, Shotgun did not require its drivers to return these excess reimbursements...Thus, Shotgun's plan also fails the third requirement for a valid accountable plan."

SHOTGUN'S PLAN WAS ABUSIVE ...PENALTIES WERE APPLIED

The Court held that Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred, and therefore, it fell under the "abusive plan" rules of Regulation Section 1.62-2(k). Accordingly, all payments made under the plan were to be treated as made under a ***non***accountable plan.

Shotgun contended that it should not be assessed penalties because it had relied upon the advice of its accountant. Apparently the accountant had provided some advice on how the plan could be modified or adjusted so that it "might" comply with Section 62(c) accountable plan rules. However, Shotgun failed to consult with its CPA "subsequent to instituting their plan to ensure proper compliance."

The Court said that although Shotgun did receive advice from an accountant regarding compliance with Section 62(c), it did not follow that advice properly. Thus, Shotgun could not claim reliance on the CPA in an effort to avoid the assessment of additional penalties.

CONCLUSION

The background facts of *Shotgun* include similarities between how Shotgun charged its customers based on distance, time required for delivery, waiting and weight, using a so-called "tag rate" and the somewhat equivalent "flat-rate" employed by dealer technicians to flag their time based on standard times for the performance of repair jobs.

It should also be noted that ILM 20006005 is ***not*** the equivalent of an IRS Coordinated Issue Paper about whose release there has been speculation for some time. This ILM is simply a Legal Memorandum authored by an employee in the Associate Chief Counsel's office. Nor is this ILM the equivalent of a published Revenue Ruling or a Revenue Procedure.

The framing of the request for ruling in the ILM as a prospective transaction belies the reality of the widespread existence of many similar plans already in place.

That is not to say that all such plans might be end-runs, shams or abuses. It is to say, rather, that these new developments—ILM 200006005 and the *Shotgun* case—emphasize the importance of being able to demonstrate right off the bat that there is truly and realistically a business connection between the payments being made and the technician's actual use of the tools for the benefit of the employer. ✱

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO FLORIDA, JANUARY, 2000

ACURA	1. Increase dealer profitability 2. Introduce competitive products in the right niches 3. Build Acura's brand image
AUDI	1. Big peaks and valleys with car distribution 2. Part order fill rate 3. More aggressive and proactive customer leasing programs
BMW	1. Constant monitoring of the Value 2000 program, a best-practices program for dealers 2. The desire for an on-time allocation and market-driven production system 3. Certification program for pre-owned and leased vehicles
BUICK	1. Expand product offerings to cover more segments of the market 2. Appeal to younger buyers 3. Increase the volume of sales per dealership, especially single-point Buick stores
CADILLAC	1. Successful launch of new products 2. Help Cadillac become a market-driven company 3. Establish proper dealer representation for Cadillac
CHRYSLER- PLYMOUTH JEEP	1. Continuing the Five Star process 2. Total integration of technology for the dealer body 3. Standardization of the Web sites
DODGE	1. Product, including a convertible 2. Quality 3. Brand differentiation
FORD	1. Customer satisfaction and continuous product quality improvement 2. E-commerce 3. Order-to-delivery system
GENERAL MOTORS NORTHEAST	1. New, more competitive products 2. More advertising 3. Competitive incentives
HONDA	1. The appropriate use of the Internet 2. Expansion of the product line 3. Continued growth of American Honda Finance Corp. subsidiary
HYUNDAI	1. Adequate supplies of vehicles and continued development of new products 2. More communication among dealers and between dealers and council 3. Increased brand recognition - for Hyundai to continue to be on more shopping lists

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO FLORIDA, JANUARY, 2000

INFINITI	1. Development and availability of new products 2. Dealer profitability 3. Improvement of volume sales
ISUZU	1. Incentives 2. Product 3. Isuzu needs to establish a captive finance unit that will support the brand
JAGUAR	1. Maintain profitability and growth 2. Internet retailing 3. Keep Jaguar a distinct brand
KIA	1. More product 2. Successful launch of new products 3. Further development of a captive finance company
LAND ROVER	1. Quality 2. Product 3. Communication with Land Rover and BMW
LEXUS	1. More product. The Lexus business is so strong, our only need is for more product. 2. Internet/e-commerce. Lexus and the dealers need to continue to work as partners to further develop the Lexus brand image and support customer needs. 3. Owner retention. Lexus, Lexus Financial Services and the dealers need to work together to maintain the owner base, promote loyalty and customer satisfaction.
LINCOLN MERCURY	1. Dealer trust 2. Internet sales 3. The shift of costs from manufacturer to dealers
MAZDA	1. Build brand image 2. Increase market share 3. Boost profitability
MERCEDES-BENZ	1. Maintain supply-demand balance plus highest quality 2. Increase home office-dealer communications through regular face-to-face meetings 3. Involve the dealer council earlier in issues and program planning
MITSUBISHI	1. Implementing its e-commerce strategy 2. Expanding to new market segments 3. Successful launch of the Eclipse Spyder and the redesigned Montero
NISSAN	1. Return Nissan to industry value leader 2. Support Nissan in becoming a market-driven auto company 3. Strengthen Nissan's captive finance company

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO FLORIDA, JANUARY, 2000

OLDSMOBILE	1. Attract new customers to new products 2. Expand product offerings to include more truck-type vehicles 3. Put enough advertising and marketing dollars toward attracting new customers
PONTIAC-GMC	1. Vehicle distribution 2. General Motors Retail Holdings 3. Regional marketing
PORSCHE	1. Lack of product 2. Lack of color and interior combinations that U.S. customers would like to see 3. Settling sport-utility issues
SAAB	1. Improve profit margins 2. Expand the product line, including a 9-3 replacement 3. Understand what GM's purchase of the rest of Saab means to dealers
SATURN	1. Regain volume momentum 2. Exploit the Internet 3. Expand product portfolio more quickly
SUBARU	1. Increase the flow of vehicles to dealers 2. Monitor General Motors' recent purchase of part of Subaru 3. Protect the market niches Subaru has carved out and dominated
SUZUKI	1. Improve and increase the dealer network 2. Modernize its marketing approach 3. Continue to add competitive product
TOYOTA	1. Protect the franchise 2. Get to the youth market 3. Maintain dealer margins
VOLKSWAGEN	1. Offering products of the highest quality 2. Distribution: having the right car at the right place with top quality 3. Developing an infrastructure for growth that will take care of customers
VOLVO	1. Successful launch of new products and management of profitable growth 2. Improving the communication and decision-making process of the dealer council 3. Customer satisfaction

FINAL REGULATIONS TELL HOW ADEQUATE DISCLOSURE WILL PREVENT THE IRS FROM REVALUING PREVIOUS GIFTS

FORMS 709 & 706

Most CPAs involved with estate planning are aware that gifts can be used very effectively in helping a dealer achieve business succession and estate tax reduction objectives.

In the past, the preparation and filing of gift tax returns was regarded by many as a relatively simple task.

Not so, anymore. Now, the preparation of gift tax returns has almost become an art form.

Why has preparation of gift tax returns become more complicated? Because IRS estate and gift tax attorneys are now paying far more attention to two matters:

1. Valuation discounts claimed in arriving at the amount of taxable gifts, and
2. How the IRS can get around the 3-year statute of limitations that would otherwise prevent it from revaluing previously reported gifts.

The March, 1997 *Dealer Tax Watch* discussed the change in Form 709 made by the IRS in connection with disclosing discounts taken in arriving at the value of reported gifts. Starting with gift tax returns for calendar 1996, a new question was added to page 2 of Form 709, the long-form U.S. Gift Tax Return, asking whether the value of any item listed in Schedule A reflected any valuation discount. The Form had–and still has–boxes corresponding to a "Yes" and "No" answer. Obviously, if any valuation discounts were claimed in arriving at the value of a gift being reported, then the "Yes" box would have to be checked.

There was another change made in connection with reporting gifts beginning with 1996 gifts. The so-called ***short-form*** gift tax return, Form 709-A, is no longer permitted to be filed to report gifts of closely-held stock, partnership interests, fractional interests in real estate or gifts "for which the value has been reduced to reflect a valuation discount."

Another article in the June, 1997 *Dealer Tax Watch* discussed the problems created because of the ability of the IRS to circumvent or get around valuations used in gift tax returns in order to later increase the effective unified tax on either subsequent gifts made by the donor or on the net assets reported in the donor's eventual estate tax return (Form 706).

Let's review the basics first in order to better understand the impact of the recently finalized regulations.

GIFTS & GIFT TAXES ARE CUMULATIVE

The gift tax rules are found in Chapter 12 of the Internal Revenue Code. Section 2501 imposes a tax on all transfers of property by gift during any calendar year. The tax imposed by Section 2501 for each calendar year is an amount equal to the excess of

1. A tentative tax, computed on the aggregate sum of the taxable gifts for the calendar year ***and*** for each of the preceding calendar periods, reduced by
2. A tentative tax, computed on the aggregate sum of the taxable gifts for each of the preceding calendar years.

In other words, the current year taxable gifts plus the sum of all prior years/periods' taxable gifts are added and the resulting total is subject to the graduated tax rates shown in the accompanying table. From this computed amount of tax, subtract the tax computed on the aggregate of the sum of all of the taxable gifts in the preceding calendar years/periods. This remainder is the tax on the current year's gifts.

The effect of all of this is simply that the amount of gift tax computed on the taxable gifts for the current year is computed at a higher graduated rate than if the tax computation for taxable gifts each year were to start at the bottom of the table as if the taxable gifts were non-cumulative.

The schedules on pages 14 and 15 (*Unified Estate and Gift Tax Rate Table* and the related *Schedule of The Phase-In of the Unified Credit Amount and Equivalent Exemption or Exclusion)* show how progressive the unified estate and gift tax can be when it is determined by adding all prior taxable gifts during lifetime and then subtracting or allowing a credit for previous gift transfer taxes paid or credits used.

Letter Ruling 9718004 was discussed in the June, 1997 *DTW*. This LTR held that prior year gift tax returns could be amended to adjust the value of past gifts for purposes of determining future gift tax liabilities. Although this LTR might be viewed as "taxpayer-friendly," it reflects only one facet of the problem many taxpayers face when the IRS seeks to challenge–usually successfully–prior gift tax valuations.

TAXPAYER RELIEF IN 1997 AND 1998

Before the Taxpayer Relief Act of 1997, ***for gift tax purposes***, the IRS generally could challenge and change the value of a gift if it acted within 3 years of

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the date of filing of the gift tax return if a gift tax had been paid with the return. If a gift tax had not been paid with the filing of the gift tax return, then even though the 3-year statute had elapsed, IRS could go back and challenge the valuation of that gift for purposes of valuing later gifts.

Gifts that could not be revalued for gift tax purposes (because a gift tax had been paid with the filing of the return and the statute of limitations had elapsed) could, nevertheless, be revalued ***for estate tax purposes*** in order to determine the appropriate portion of the *Unified Estate Tax Table* to be applied to the value of the property owned by the donor at the date of his death. To partially eliminate these revaluation controversies and uncertainties, the Tax Reform Act of 1997 and the Internal Revenue Service Restructuring and Reform Act of 1998 provided some relief.

The Taxpayer Relief Act of 1997 provided that for gifts made after August 5, 1997, the IRS cannot go back and challenge the taxpayer's valuations of the gifted property once the statute of limitations has run. Ordinarily, the statute would run three years after the gift tax return was filed. This taxpayer protection was included in TRA '97 because in a 1990 Tax Court case (*Smith v. Commissioner*), the Tax Court held that a taxpayer's gift could be revalued for purposes of computing the estate tax due on assets included in the (deceased) taxpayer's estate on Form 706. This result was allowed even though the statute of limitations had already run out on the previous gift tax return (Form 709).

As indicated earlier, the consequence of all this is simply that reflecting a higher valuation for the previously made gifts will result in a higher incremental or marginal estate tax rate being applied to the assets that are included in the estate. A related recordkeeping problem was that the taxpayer would have to save indefinitely all of the information regarding the prior gift tax transfers reported on Form(s) 709 because that information might become critical in the future in the final estate tax return (Form 706) filing process.

In order to deal with these problems, the Tax Reform Act of 1997 set two conditions that, if met, will prevent the IRS from going back and revaluing prior gifts. These conditions are that (1) taxpayers must ***adequately disclose*** the value of a gift on a gift tax return and (2) the statute of limitations must have expired for purposes of assessing a gift tax.

If both conditions are met, the valuation used in prior gift tax returns cannot be challenged by the IRS at a later date either in connection with subsequent gifts or in connection with that donor's estate taxation process.

FINALITY...AT LAST

To coordinate these changes regarding the valuation of prior gifts in determining estate and gift tax liability and the period of limitations for assessing and collecting gift tax, Section 6501(c)(9) requires that a gift must be ***adequately disclosed*** on a gift tax return in order to commence the running of the period of limitations on assessment with respect to the gift. Once the period of limitations expires, the amount of that gift as reported on the gift tax return may not be adjusted for purposes of determining future gift and/or estate tax liability.

Regulations providing guidance on what constitutes ***adequate disclosure*** were issued in proposed form on December 22, 1998. Written comments responding to these proposed Regulations were followed by a hearing on them on April 28, 1999, at which time oral testimony was presented. Following that hearing, the Service considered the written and oral comments submitted, and Regulations in final form were issued on December 3, 1999. For more on this, see pages 25-28.

REGULATION COMPLEXITY

Many factors contribute to the complexity of the final Regulations. Under the unified rate structure for taxing gifts and property held at death, there are three levels of exposure to the IRS revaluation of previous gifts. ***First***, there is exposure to revaluation of the gift itself in the Form 709, U.S. Gift Tax Return, filed for the year in which the gift is made. This can occur any time before the 3-year statute of limitations which runs from the later of the date the gift tax return is filed or the date the gift tax return was due.

The ***second potential*** for exposure to the IRS revaluation of a previously made gift occurs whenever that same donor subsequently makes additional taxable gifts. This exposure occurs because those gifts must be added to the taxable gifts made in previous years in order to arrive at the "total taxable gifts" in the cumulative computation of the tax on all taxable gifts (prior plus current).

The ***third and final level of exposure*** at which a previously made gift may be revalued occurs in the computation of the donor's estate tax when all prior taxable gifts made during life are aggregated with all property owned by the decedent/donor at the date of death.

The effective dates of these new rules also contribute to the complexity of the Regulations. The effective date of August 5, 1997 requires discussion of the treatment of gifts before and after that date, in terms of their treatment relative to each of the three

see **REVALUING PREVIOUS GIFTS**, page 16

UNIFIED TRANSFER TAX FOR TAXABLE GIFTS AND ESTATES

FORM 709
FORM 706

COLUMN A TAXABLE AMOUNT OVER-	COLUMN B TAXABLE AMOUNT NOT OVER-	COLUMN C TAX ON AMOUNT IN COLUMN A	COLUMN D RATE OF TAX ON EXCESS OVER AMOUNT IN COLUMN A
------	$ 10,000	------	18%
$ 10,000	20,000	$ 1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,800	49%
2,500,000	3,000,000	1,025,800	53%
3,000,000	10,000,000	1,290,800	55%
10,000,000	21,040,000	5,140,800	60%
21,040,000	------	11,764,800	55%

NOTES TO UNIFIED TRANSFER TAX TABLE

1. The transfer tax rates are integrated for lifetime gifts and these rates apply to the value of what is left in one's estate at one's death. Total taxable gifts during one's lifetime are added to the value of the net taxable estate to determine the Taxable Amount in Column A for estate tax purposes.
2. From 1997 through 2006, the unified credit amount is scheduled to rise from $600,000 to $1,000,000. The current unified credit amount is not obvious at first glance. But it is easily located a little past the mid-point in the $500,000 to $750,000 "Taxable Amount" bracket for which the tax rate is 37%.
3. Once the unified credit has been used against prior taxable gifts, or against a combination of prior taxable gifts (if any) plus a portion of the taxable estate, the tax rate applicable to the first taxable dollar being transferred will be 37% until the year 2004.
4. To the extent that stock (and other property interest) valuation discounts are claimed and are allowable, those amounts never even come into the picture.
5. The benefit of the unified credit is phased out for larger estates. See the $10,000,000 taxable amount line which reflects a 60% rate of tax on taxable transfers by gifts or at death or by any combination thereof between the amounts of $10,000,000 and $21,040,000.

For Decedents Dying in, or for Gifts During	*Unified Credit Amount*	*Equivalent Exemption or Exclusion*
1997 ... NO CHANGE	$192,800	$ 600,000
1998	202,050	625,000
1999	211,300	650,000
2000 AND 2001	220,550	675,000
2002 AND 2003	229,800	700,000
2004	287,300	850,000
2005	326,300	950,000
2006 AND BEYOND	345,800	1,000,000

WHY GIFTS ARE GOOD

Despite the unified transfer tax rates, ***lifetime gifts are almost always far more attractive*** than deathtime transfers for several reasons.

1. There is a $10,000 annual gift tax exclusion which is available on a per donor, per donee basis.
2. This $10,000 annual exclusion is doubled so that spouses can together give $20,000 per donee, per year, whether or not they each own an interest in the asset being gifted.
3. The point in time at which lifetime gifts are valued <u>is as of the date of gift</u> and not the value as of the date of death. Therefore, by gifting property that is likely to appreciate, the post-gift appreciation is eliminated from the donor's estate if the donor survives the gift by 3 years. The Economic Recovery Tax Act of 1981 removed from the unified rate structure any appreciation occurring on gifted property after the date of gift if the donor survived the gift by 3 years.
4. Post-gift income generated by the gifted asset is removed from the donor's estate and therefore is not subject to a transfer tax.
5. By making gifts of minority interests in a non-publicly held entity, a donor may qualify for substantial discounts. Any valuation discounts claimed must be reasonable ... but there is a wide range of possibilities and qualified experts often view the value of the same company's stock very differently.

The bottom line is that some of the most effective gift and estate plans have been accomplished by small, steady doses of annual gifts at or just below the minimum $10,000 per donee exception. Coupled with spousal consent, significant amounts of value in the form of current and future appreciation can be transferred over time to children and other donees and often with significant annual reduction in income tax burdens.

Lifetime gifts and the resulting special exclusions and treatments summarized above should not necessarily be taken for granted. They are available today - and current talk of *liberalization* or even repeal of the estate tax may not come to pass - or may come to pass with various adverse trade-offs.

(Continued from page 13)

levels of exposure identified above. Also, the Regulations concerning what will constitute ***adequate disclosure*** have their own promulgation date, and since gift tax returns are filed on an annual basis reflecting all gifts made within a calendar year, the effective dates are somewhat blurred, especially with respect to gifts made during the period from January 1, 1997 through August 5, 1997.

Adding further to the complexity of these Regulations is the fact that they also contain special rules which are provided for non-gift transfers which may be less obvious...but which still may have to be reported in gift tax returns in order to get the statute of limitations to start running.

A portion of the Regulations discusses whether or not revaluation of prior gift adjustments will be made in connection with gifts that are made before or after August 5, 1997. Another portion of the Regulations dealing with the exceptions to the general period of limitations on assessment and collection of tax (i.e., the statute of limitations portion of the Regulations) discusses the ***adequate disclosure*** standard in terms of whether or not it is satisfied for gifts made after December 31, 1996 and/or subsequent calendar years which are reported in gift tax returns filed on an annual basis.

The examples presented on pages 22-24 illustrate many of these overlapping considerations.

GIFTS BEFORE AUGUST 6, 1997 WILL ALWAYS BE SUBJECT TO REVALUATION CHALLENGE FOR ESTATE TAX PURPOSES

The Regulations provide that for purposes of determining the value of adjusted taxable gifts in connection with the computation of a taxable ***estate*** under Section 2001(b), if the gift was made prior to August 6, 1997, the value of that gift may be adjusted ***at any time***, even if the time within which a gift tax may be assessed has expired under the statute of limitations.

Thus, the value of any or all adjusted taxable gifts made before August 6, 1997 may be revalued for estate tax computation purposes at any time—even if the 3-year statute of limitations has expired. It is only for adjusted taxable gifts made after August 5, 1997 (and Section 2701(d) taxable events occurring after that date), that the IRS is prevented from making any adjustment or challenge, (in connection with estate computations) unless such adjustment or challenge is made before the 3-year statute of limitations has expired on that gift tax return.

If the 3-year statute of limitations under Section 6501 has expired with respect to a gift made after August 5, 1997, then the valuation of that gift will not be changed in any subsequent estate tax valuation matters. Note: the statute of limitations, as discussed later, will only start running if the gift is adequately disclosed in the gift tax return filed. Furthermore, this rule applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law. This rule applies to gifts made after August 5, 1997, if the gift tax return for the calendar period in which the gift is made is filed after December 3, 1999.

REVALUATION FOR GIFT TAX PURPOSES

Gifts before August 6, 1997 must have paid a gift tax. Gifts made before August 6, 1997 receive special attention depending on whether or not a gift tax was assessed or paid in connection with that pre-August 6, 1997 gift. If (1) a gift was made prior to August 6, 1997, if (2) the statute of limitations has run on that gift tax return, and if (3) a tax has been assessed or paid for such prior calendar period, then the valuation of the gift for purposes of arriving at the correct amount of taxable gifts for the preceding calendar periods will be the value used in that gift tax return.

The Regulation states, "However, this rule does not apply where no tax was paid or assessed for the prior calendar period." The Regulations further state that this rule does not apply to adjustments involving issues other than valuation. This means that questions involving the interpretation of the gift tax law relating to that prior return may be reopened.

Accordingly, if no gift tax was paid relative to the gift before August 6, 1997, then the IRS may challenge the valuation of that pre-August 6, 1997 gift for purposes of the computation of gift tax liability in subsequent years. Those are the rules for gifts made before August 6, 1997 as to their subsequent gift tax valuation potential.

Gifts after August 5, 1997. For gifts that were made after August 5, 1997 (and Section 2701(d) taxable events occurring after that date), if the 3-year statute of limitations has expired, then the valuation of the taxable gift will be the amount that was finally determined for gift tax purposes if that gift had been ***adequately disclosed*** in the gift tax return. This rule preventing a revaluation of the gift will apply to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

Three examples illustrating the effective date rules appear on page 24. Note that in Example 2, the "exchange for a promissory note signed by B" was not thought nor intended by the parties to be a gift, and accordingly, it was not reported on the Form 709. As a consequence, the later determination by the IRS that →

the sales price was inadequate led to the result that gift tax could be assessed on that transaction even though the 3-year statute of limitations was thought to have expired. In addition, the change in valuation was also reflected in the valuation of subsequent gifts in subsequent returns. The third example (i.e., Example 3) illustrates the fact that for any gifts before August 6, 1997, there can always be a revaluation in connection with determining the donor/decedent's adjusted taxable gifts in computing his ***estate*** tax liability.

The favorable rules applying to gifts after August 5, 1997 apply only if the gift tax return for the calendar period for which the gift is reported is filed after December 3, 1999.

WHAT CONSTITUTES *ADEQUATE DISCLOSURE*?

The final Regulations provide that if a transfer of property is not ***adequately disclosed*** on a gift tax return (From 709) or in a statement attached to the return filed for the calendar period in which the transfer occurs, then any gift tax on the transfer may be assessed at any time.

In other words, if the disclosures of the gift satisfy the ***adequate disclosure*** requirements of Reg. Sec. 301.6501(c)-1(f), then the normal 3-year statute of limitations will apply, and the IRS cannot revalue the gift after the statute of limitations on that year's gift tax return has run.

The caption for the Regulation reads "Gifts Made After December 31, 1996, Not Adequately Disclosed on the Return." Regulation Section 301.6501(c)-1(f)(2) provides that a transfer will be adequately disclosed on the 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 so reported. This Regulation lists the information that must be disclosed in order to achieve ***adequate disclosure***. These elements are shown on page 18.

QUALIFIED APPRAISAL AND APPRAISER STANDARDS

The Regulations provide that taxpayers can satisfy the detailed valuation information requirement in (iv) by submitting instead an appraisal that meets certain requirements if that appraisal has been prepared by a "qualified" appraiser.

These appraisal and appraiser requirements are shown on page 19.

SPECIAL RULES FOR NON-GIFTS

Closely-held businesses inevitably engage in many kinds of transactions with family members that have potential gift tax implications. Examples include the payment of (excessive) salaries, rent, fees and other similar items. The final Regulations address some of the possible gift implications.

Completed transfers to members of the transferor's family, as defined in Section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be "*adequately disclosed*," even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes.

For example, in the case of salary paid to a family member employed in a family-owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns.

The Regulations provide that any other completed transfer that is reported in its entirety on a gift tax return as not constituting a transfer by gift will be considered ***adequately disclosed*** only if ***all*** of the following information is provided on, or attached to, the gift tax return:

DISCLOSURE REQUIREMENTS FOR NON-GIFT TRANSFERS

1. A description of the transferred property and any consideration received by the transferor.
2. The identity of, and relationship between, the transferor and each transferee,
3. If the property is transferred in trust, the trust's tax identification number, and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument,
4. 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, and
5. ***An explanation of why the transfer is not a transfer by gift under Chapter 12 of the Internal Revenue Code.***

More discussion of the intricacies of these special rules for so-called non-gift transactions can be found in three places:

1. See Example #6 of the *Examples of Adequate and Inadequate Disclosures* on page 23.

2. See Example #2 of the *Illustrations of Effective Date Rules* on page 24.

3. See the discussion on non-gift transactions included in the *Criticisms & Concerns Over Proposed Regulations* on page 27. This discussion is especially

see **REVALUING PREVIOUS GIFTS**, page 21

ADEQUATE DISCLOSURE STANDARDS

Transfers of property by gift reported on a gift tax return (Form 709) will be considered ***adequately disclosed*** if the return - or a statement attached to the return - provides all of the following information:

(i) A description of the transferred property and any consideration received by the transferor;

(ii) The identity of, and relationship between, the transferor and each transferee;

(iii) If the property is transferred in trust, 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;

(iv) A detailed description of the method used to determine the fair market value of property transferred, including ***any financial data*** (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, ***any restrictions*** on the transferred property that were considered in determining the fair market value of the property, and ***a description of any discounts***, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.

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, 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 of this paragraph (f)(2)(iv).

In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. 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 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), 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.

If 100 percent 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. 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 in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest; and

Note: Reg. Sec. 301.6501-1(f)(3) allows for the submission of appraisals in lieu of this information. See facing page for qualified appraisal & appraiser standards.

(v) 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.

QUALIFIED APPRAISAL & APPRAISER STANDARDS

The requirements of paragraph (f)(2)(iv) will be satisified if the donor submits an appraisal of the transferred property that meets the following requirements:

- The appraisal is prepared by an ***APPRAISER*** who satisfies all of the following requirements:

    1. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

    2. Because 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.

    3. The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

- The ***APPRAISAL*** contains all of the following:

    1. The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

    2. A description of the property.

    3. A description of the appraisal process employed.

    4. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

    5. 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.

    6. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

    7. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

    8. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset- based approaches, merger-acquisition transactions, etc.

(see facing page for adequate disclosure standards)

 (Continued from page 17)

SUGGESTIONS FOR WORKING WITH THE NEW *ADEQUATE DISCLOSURE* STANDARDS FOR REPORTING GIFTS

PRACTICE GUIDE

1. ***Review gift tax returns filed for 1997-1998-1999 to determine whether the filing of amended gift tax returns might be appropriate.***

   The adequate disclosure requirements are applicable to gifts made after December 31, 1996, for which the gift tax return for such calendar year is ***filed after December 3, 1999.*** Accordingly, gift tax returns previously filed for the years 1997 and 1998 may not reflect the degree of disclosure now called for in the final Regulations in order to satisfy the ***adequate disclosure*** standards.

   Similarly, if 1999 gifts were reported on Form 709 earlier this year but the adequate disclosure Regulations, as finalized, were not taken into consideration, it may be appropriate to file an amended gift tax return for 1999 in order to assure the start of the running of the statute of limitations on the valuations used.

2. It is clear from the Regulations that if a donor–or a donor and his spouse who elected to split gifts–did not previously file a gift tax return because the amount of the gift (i.e. the valuation, after discounts) was less than the $10,000 minimum amount for filing, perhaps they should now consider filing gift tax returns in order to start the statute of limitations running on those gifts.

   Without the filing of a gift tax return, the statute of limitations will never start to run.

3. Where gifts of stock in trust are involved, it may be advisable to attach a copy of the entire trust document. This may be safer than trying to come up with a "brief description of the terms of the trust" and risking that the IRS might contend that the "description" provided was not sufficient (i.e., that it was ***in***adequate).

4. It would appear that one cannot submit "too much" information with respect to lower-tiered entities and/or new types of entities. Accordingly, consider attaching copies of family limited partnership agreements, etc., where these are integral to the overall gifting transactions.

5. If family limited partnerships are involved, separate as much as possible the steps by which the entity is created from the (subsequent) steps in which interests in it are gifted.

6. If you are planning to submit an appraisal in lieu of the detailed valuation information required for adequate disclosure, carefully interview the appraiser. Ask whether the appraiser will prepare a complete appraisal report meeting all of the standards and other requirements of USPAP (Uniform Standards of Professional Appraisal Practice).

7. Review transactions involving family members such as rent or compensation payments to consider whether they are excessive or might be subject to challenge by the IRS as "non-gift completed transfers." In connection with family type transactions, do not overlook the filing of appropriate Forms 1099 since the Service may consider the filing of these information returns as important to its "being notified" of the occurrence of certain transactions.

8. Although the final Regulations provide only one example (i.e., salary paid to a family member in a family-owned business), other possibilities include rentals paid to family members, other fees for service, and/or inadequate pricing for the transfer of goods and services between related companies owned by different family members.

9. In connection with other transfers under the "non-gift completed transfers or transactions" provisions, remember that even sales thought to be at fair market value prices by both parties may be challenged by the IRS as part gifts, for which the statute of limitations will not run unless a gift tax return has been filed with adequate disclosures therein.

10. Review business succession transactions, including the terms of redemption agreements effected under Section 302(b)(3), to determine whether latent gift tax exposure may be present.

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insightful for estate planners because it points out the even higher level of disclosure required for non-gift transactions that arises in the context of transactions that are ***not*** in the ordinary course of operating a business.

SPECIAL RULES FOR INCOMPLETE GIFTS & SPLIT-GIFTS

The Regulations also provide that *adequate disclosure* of a transfer that is reported as a complete gift on the gift tax return will commence the period of limitations for assessment of gift tax on the transfer, even if that transfer is ultimately determined to be an incomplete gift.

A husband and wife may elect, under Section 2513, to treat a gift made to a third party as made one-half by each spouse. If this election to split gifts has been made, another special rule provides that the requirements for *adequate disclosure* will be satisfied with respect to the gift which is deemed made by the consenting spouse if the gift tax return filed by the donor spouse (i.e., the one who owned and transferred the property) satisfies the *adequate disclosure* requirements.

The Regulations include an effective date provision which states that the *adequate disclosure* provisions are applicable "to gifts made after December 31, 1996, for which the gift tax return for such calendar year is filed after December 3, 1999." For examples illustrating the *adequate disclosure* provisions, see pages 22 and 23.

These examples point out some of the subtleties that advisors need to consider. For instance, the fourth example sends a caution to anyone who might otherwise be tempted to skimp on the disclosure in connection with lower-tiered entities. Example 6 highlights the risk associated with salary payments that might be excessive. However, it does not discuss any of the income tax (i.e., constructive dividends) aspects, nor does it discuss whether the filing of Forms 1099 and 1096 might be a significant element in the proper overall "disclosure" in connection with payments made in the ordinary course of operating a business.

MANY ONEROUS REQUIREMENTS IN THE PRELIMINARY REGULATIONS WERE REMOVED IN THE FINAL VERSION

As indicated earlier, the preliminary Regulations were released on December 22, 1998. Written responses to these proposed Regulations were submitted, and after a hearing on April 28, 1999, the Regulations were issued in their final form on December 3, 1999. In some cases, the final Regulations relaxed the requirements in the proposed Regulations by removing some detailed or broad disclosure requirements. Some of the differences between the preliminary and the final version of the Regulations point out special problem areas lurking beneath the surface of these new rules.

For example, one must appreciate the special reporting distinction between (1) non-gift transfers and transactions made in the *ordinary course of business* versus (2) those not made in the ordinary course of business.

CONCLUSION

Practitioners need to be aware of what the final Regulations now say will constitute ***adequate disclosure*** sufficient to start the running of the statute of limitations on gifts. These disclosure requirements should be carefully considered in evaluating the role of gifting in recent and in future business succession and estate planning activities.

The final Regulations may contain some surprises for anyone who thought they could keep a low profile on certain valuation issues and still have their clients enjoy the benefit of protection under the statute of limitations. That simply can't and won't happen.

The proper treatment of what might be questionable transfers between family members in a business setting are prominently addressed in the recently finalized Regulations. Practitioners should review these requirements to be sure that proper/precautionary disclosures have been made. Otherwise, the IRS might claim that the statute of limitations never started to run on these prior transactions which were never thought to have gift implications. Then there will be no way to prevent the IRS from assessing gift taxes well beyond three years from the original transactions.

Practitioners shouldn't interpret these new rules as a deterrent to the continued effective use of gifts. The phasing-in of higher unified credit amounts and the well-established benefits achieved from consistent utilization of gifts in the overall planning process should outweigh the disclosure complications that the new requirements present.

For more information on the final Regulations, see the following supplementary information:

Examples of Adequate and Inadequate Disclosures on pages 22-23.

Illustrations of Effective Date Rules on page 24.

Criticisms & Concerns Over Proposed Regulations on pages 25-28.

Example 1. (i) ***Facts.*** In 2001, A transfers 100 shares of common stock of XYZ Corporation to A'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, determined in accordance with Sec. 25.2512-2(b) of this chapter (based on the mean between the highest and lowest quoted selling prices), is $150.00. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A reports the gift to A's child of 100 shares of common stock of XYZ Corporation with a value for gift tax purposes of $15,000. A 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.

(ii) ***Application of the adequate disclosure standard.*** A has adequately disclosed the transfer. Therefore, the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

Example 2. (i) ***Facts.*** On December 30, 2001, A transfers closely-held stock to B, A's child. A determined that the value of the transferred stock, on December 30, 2001, was $9,000. A made no other transfers to B, or any other donee, during 2001. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information required under paragraph (f)(2) of this section such that the transfer is adequately disclosed. A claims an annual exclusion under section 2503(b) for the transfer.

(ii) ***Application of the adequate disclosure standard.*** Because the transfer is adequately disclosed under paragraph (f)(2) of this section, the period of assessment for the transfer will expire as prescribed by section 6501(b), notwithstanding that if A's valuation of the closely-held stock was correct, ***A was not required to file a gift tax return*** reporting the transfer under section 6019. After the period of assessment has expired on the transfer, the Internal Revenue Service is precluded from redetermining the amount of the gift for purposes of assessing gift tax or for purposes of determining the estate tax liability. Therefore, the amount of the gift as reported on A's 2001 Federal gift tax return may not be redetermined for purposes of determining A's prior taxable gifts (for gift tax purposes) or A's adjusted taxable gifts (for estate tax purposes).

Example 3. (i) ***Facts.*** A owns 100 percent 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, A transfers 20 percent of the X stock to B and C, A's children, in a transfer that is not subject to the special valuation rules of section 2701. 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. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information required under paragraph (f) (2) of this section including a statement reporting the fair market value of 100 percent 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. A also attaches a statement regarding the determination of value that includes a discussion of the discounts claimed and how the discounts were determined.

(ii) ***Application of the adequate disclosure standard.*** A has provided sufficient information such that the transfer will be considered adequately disclosed and the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

__Example 4.__ (i) ***Facts.*** A owns a 70 percent limited partnership interest in PS. PS owns 40 percent of the stock in X, a closely-held corporation. The assets of X include a 50 percent 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, A transfers a 25 percent limited partnership interest in PS to B, A's child. On the Federal gift tax return, Form 709, for the 2001 calendar year, A reports the transfer of the 25 percent limited partnership interest in PS and that the fair market value of 100 percent of PS is $y and that the value of 25 percent of PS is $z, reflecting marketability and minority discounts with respect to the 25 percent interest. However, ***A does not disclose that PS owns 40 percent of X, and that X owns 50 percent of PB and that***, in arriving at the $y fair market value of 100 percent 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.

(ii) ***Application of the adequate disclosure standard. The information on the lower tiered entities is relevant and material in determining the value of the transferred interest in PS.*** Accordingly, because A has failed to comply with requirements of paragraph (f)(2)(iv) of this section regarding PS's interest in X, X's interest in PB, and PE's interest in the commercial real property, ***the transfer will not be considered adequately disclosed and the period of assessment for the transfer under section 6501 will remain open indefinitely.***

__Example 5.__ The facts are the same as in Example 4 except that A submits, with the Federal tax return, an ***appraisal*** of the 25 percent limited partnership interest in PS that satisfies the requirements of paragraph (f)(3) of this section in lieu of the information required in paragraph (f)(2)(iv) of this section. Assuming the other requirements of paragraph (f)(2) of this section are satisfied, the transfer is considered adequately disclosed and the period for assessment for the transfer under Section 6501 will run from the time the return is filed (as determined under section 6501(b) of this chapter).

__Example 6.__ A owns 100 percent of the stock of X Corporation, a company actively engaged in a manufacturing business. B, A's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. B reports the annual salary as income on B's income tax returns. In 2001, A transfers property to family members and files a Federal gift tax return reporting the transfers. However, ***A does not disclose the 2001 salary payments made to B. Because the salary payments were reported as income on B'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 B, reported on the gift tax return must satisfy the adequate disclosure requirements under paragraph (f)(2) of this section in order for the period of assessment under section 6501 to commence to run with respect to those transfers.

ILLUSTRATIONS OF EFFECTIVE DATE RULES

Example 1. (i) ***Facts.*** In 1996, A transferred closely-held stock in trust for the benefit of B, A's child. A timely filed a Federal gift tax return reporting the 1996 transfer to B. No gift tax was assessed or paid as a result of the gift tax annual exclusion and the application of A's available unified credit. In 2001, A transferred additional closely-held stock to the trust. A's Federal gift tax return reporting the 2001 transfer was timely filed and the transfer was adequately disclosed under Reg. Sec. 301.6501(c)-I(f)(2). In computing the amount of taxable gifts, A claimed annual exclusions with respect to the transfers in 1996 and 2001. In 2003, A transfers additional property to B and timely files a Federal gift tax return reporting the gift.

(ii) ***Application of the rule limiting adjustments to prior gifts.*** Under Section 2504(c), in determining A's 2003 gift tax liability, the amount of A's 1996 gift can be adjusted for purposes of computing prior taxable gifts, since that gift was made prior to August 6, 1997. Adjustments can be made with respect to the valuation of the gift and legal issues presented (for example, the availability of the annual exclusion with respect to the gift). However, A's 2001 transfer was adequately disclosed on a timely filed gift tax return and, thus, the amount of the 2001 taxable gift by A may not be adjusted (either with respect to the valuation of the gift or any legal issue) for purposes of computing prior taxable gifts in determining A's 2003 gift tax liability.

Example 2. (i) ***Facts.*** In 1996, A transferred closely-held stock to B, A's child. A timely filed a Federal gift tax return reporting the 1996 transfer to B and paid gift tax on the value of the gift reported on the return. On August 1, 1997, A transferred additional closely-held stock to B in exchange for a promissory note signed by B. Also, on September 10, 1997, A transferred closely-held stock to C, A's other child. On April 15, 1998, A timely filed a gift tax return for 1997 reporting the September 10, 1997, transfer to C and, under Reg. Sec. 301.6501(c)-I(f)(2) adequately disclosed that transfer and paid gift tax with respect to the transfer. However, A believed that the transfer to B on August 1, 1997, was for full and adequate consideration and A did not report the transfer to B on the 1997 Federal gift tax return. In 2002, A transfers additional property to B and timely files a Federal gift tax return reporting the gift.

(ii) ***Application of the rule limiting adjustments to prior gifts.*** Under Section 2504(c), in determining A's 2002 gift tax liability, the value of A's 1996 gift cannot be adjusted for purposes of computing the value of prior taxable gifts, since that gift was made prior to August 6, 1997, and a timely filed Federal gift tax return was filed on which a gift tax was assessed and paid. However, A's prior taxable gifts can be adjusted to reflect the August 1, 1997, transfer because, although a gift tax return for 1997 was timely filed and gift tax was paid, under Reg. Sec. 301.6501(c) - l(f) the period for assessing gift tax with respect to the August 1, 1997, transfer did not commence to run since that transfer was not adequately disclosed on the 1997 gift tax return. Accordingly, a gift tax may be assessed with respect to the August 1, 1997, transfer and the amount of the gift would be reflected in prior taxable gifts for purposes of computing A's gift tax liability for 2002. A's September 10, 1997, transfer to C was adequately disclosed on a timely filed gift tax return and, the amount of the September 10, 1997, taxable gift by A may not be adjusted for purposes of computing prior taxable gifts in determining A's 2002 gift tax liability.

Example 3. (i) ***Facts.*** 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.

(ii) ***Application of the rule limiting adjustments to prior gifts.*** Under Section 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. However, for purposes of determining A's adjusted taxable gifts in computing A's estate tax liability, the gifts may be adjusted.

CRITICISMS & CONCERNS OVER PROPOSED REGULATIONS

SOME ALLAYED, SOME NOT MADE IN FINAL REGULATIONS

1. Requirements for Adequate Disclosure

Under Section 6501 (c) (9) , the period of limitations on the assessment of gift tax with respect to a gift will commence to run only if the gift is adequately disclosed on the gift tax return. The proposed regulations provide a list of information required to satisfy the adequate disclosure standard.

In general, the comments objected to the quantity, detail, and nature of the information required under the proposed regulations. In some cases, information required in the proposed regulations is not required in the final regulations. However, Treasury and the IRS continue to believe that the adequate disclosure rule was intended to afford the IRS a viable means to identify the returns that should be examined, with a minimum expenditure of resources. Further, the more complete and comprehensive the information filed with the return is, the more readily the IRS will be able to identify the returns that should not be examined, thus saving taxpayers needless expenditures of time and money.

Some commentators argued that Congress intended that the new adequate disclosure requirements be the same as the existing disclosure requirements under prior Section 6501(c)(9) for pre-August 5, 1997 gifts of property subject to the special valuation rules of Sections 2701 and 2702. Therefore, the commentators suggested that the IRS adopt the disclosure requirements under Sec. 301.6501(c)-1(e)(2) for transfers of those interests. This suggestion was not adopted. The IRS and Treasury believe it is necessary to expand on those disclosure requirements to address the broader range of transfers covered by the new legislation, as well as transactions and entities that may not have been prevalent when the prior regulations were promulgated.

Under the proposed regulations, if property is transferred in trust, taxpayers are required to provide a brief description of the terms of the trust. In response to comments, the final regulations provide that taxpayers may submit a complete copy of the trust document in lieu of a description of the trust terms.

The proposed regulations require the submission of a detailed description of the method used in determining the fair market value of the property, including "any relevant financial data." Commentators contended that "any relevant financial data" is a subjective concept that lacks specificity. Rather, the regulations should specify exactly what financial data must be submitted, such as balance sheets, net earnings statements, etc. In response to these comments, the final regulations require that any financial data that was used in valuing the interest must be submitted. This ensures that the information requested is available and was deemed relevant by the person valuing the interest.

Several commentators expressed concern over the requirement in the proposed regulations that, if a less-than-100-percent interest in a non-actively traded entity is transferred, the taxpayer must submit a statement regarding the fair market value of 100 percent of the entity determined without regard to any discounts. It was contended that a less-than-100-percent interest in an operating company may not be valued based on a pro rata portion of the value of 100 percent of the entity; rather the appraiser often will determine the value based on indicia other than the value of the entire entity, such as the price/ earnings ratio of stock in comparable publicly-traded entities. Because the entire entity is not valued in these situations, valuing 100 percent of the entity would not be relevant.

CRITICISMS & CONCERNS OVER PROPOSED REGULATIONS

One comment stated that this requirement would be reasonable in valuing an interest in nonactively-traded entities, such as entities holding securities or real estate, since in those cases the value of an interest in the entity would be determined based on a pro rata portion of the value of 100 percent of the entity.

In response to these comments, the final regulations do not require a statement of the fair market value of 100 percent of the entity (without regard to any discounts), if the value of the interest in the entity is properly determined without using the net asset value of the entire entity. If 100 percent 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.

The proposed regulations also require valuation information for each entity (and its assets) that is owned or controlled by the entity subject to the transfer. Comments indicated that this requirement would be difficult to satisfy, because in some cases the information would not be within the control of the taxpayer and the entity subject to the transfer would not normally be required to maintain the financial records with respect to lower-tiered entities. The comments suggested that information on the lower-tiered entities should be required only to the extent such information is essential to a reasonable appraisal of the interest transferred and is in the personal control of the taxpayer. Many commentators suggested that the regulations require the submission of only that information that a qualified and competent appraiser would use in valuing the interest. In response to these comments, the final regulations provide that the information on the lower-tiered entities must be submitted if the information is relevant and material in determining the value of the interest in the entity.

Finally, comments suggested that a properly completed appraisal would contain all the information that is material and relevant to the valuation of the transferred property and, therefore, should be sufficient to satisfy any disclosure requirement. Accordingly, under the final regulations, an appraisal satisfying specific requirements may be submitted in lieu of a detailed description of the method used to determine the fair market value and in lieu of information regarding tiered entities.

The proposed regulations require a statement of relevant facts that would apprise the IRS of the nature of ***ANY*** potential gift tax controversy concerning the transfer, or instead of that statement, a concise description of the legal issue presented by the facts. This requirement is similar to the disclosure required to avoid the accuracy-related penalty under Section 6662. It was intended to enable the IRS to easily identify issues presented so that the IRS could evaluate whether an examination is warranted during the initial review of the gift tax return.

Commentators indicated that the requirement was too subjective and open-ended, since it would be difficult for a practitioner to identify or anticipate "any" potential controversy. In response to these comments, that requirement has been eliminated from the final regulations. The proposed regulations also require that the taxpayer submit a statement describing any position taken that is contrary to any temporary or final regulations or any revenue ruling. Commentators were concerned that this requirement could be interpreted as including both regulations and revenue rulings that are published after the gift tax return is filed that interpret earlier IRS positions. In response to these comments, the final regulations limit the required statement to positions taken that are contrary to any proposed, temporary or final regulation, and any revenue ruling published at the time the transfer occurred.

CRITICISMS & CONCERNS OVER PROPOSED REGULATIONS

Commentators also noted that, under the proposed regulations, if a taxpayer failed to provide, for example, one item of information, the adequate disclosure requirement would not be satisfied, regardless of the significance of the item. The comments suggested that "substantial compliance" with the requirements of the regulations or a good-faith effort to comply should be deemed actual compliance. This suggestion was not adopted in view of the difficulty in defining and illustrating what would constitute substantial compliance. However, it is not intended that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided.

In response to comments, a rule was added regarding the application of the adequate disclosure rules in the case of "split gifts" under Section 2513. Under this rule, gifts attributed to the non-donor spouse are deemed to be adequately disclosed if the gifts are adequately disclosed on the return filed by the donor spouse.

2. Finality With Respect to Adequately Disclosed Gifts

Under the proposed regulations, if a transfer is adequately disclosed on the gift tax return, and the period for assessment of gift tax has expired, then the IRS is foreclosed from adjusting the value of the gift under Section 2504(c) (for purposes of determining the current gift tax liability) and under Section 2001(f) (for purposes of determining the estate tax liability). However, the IRS is not precluded from making adjustments involving legal issues, even if the gift was adequately disclosed. This position was based on longstanding regulations applying Section 2504(c) and relevant case law.

Comments suggested that this rule is contrary to Congressional intent in enacting Section 2001(f) and amending Section 2504(c) to provide a greater degree of finality with respect to the gift and estate tax statutory scheme. In response to these comments, the final regulations preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift.

3. Non-Gift Transactions

Under the proposed regulations, a completed transfer that did not constitute a gift would be considered adequately disclosed if the taxpayer submitted the information required for adequate disclosure and an explanation describing why the transfer was not subject to the gift tax. One commentator suggested that the adequate disclosure requirement should be waived if the taxpayer reasonably, in good faith, believes the transfer is not a gift (for example, a salary payment made to a child employed in a family business). Another commentator noted that the standard for adequate disclosure is higher for a "non-gift" than it is for a gift transaction since, in the non-gift situation, the donor must provide all the information required by the regulation and a statement why the transaction is not a gift. Another comment requested more guidance for reporting non-gift business transactions.

In response to the comments, the final regulations limit the information required in a non-gift situation. In addition, the final regulations provide that completed transfers to members of the transferor's family (as defined in Section 2032A(e)(2)) in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax return, if the item is properly reported by all parties for income tax purposes. For example, in the case of a salary payment made to a child of the donor employed in the donor's business, the transaction will be treated as adequately disclosed for gift tax purposes if the salary payment is properly reported by the business and the child on their income tax returns. This exception only applies to transactions conducted in the ordinary course of operating a business. It does not apply, for example, in the case of a sale of property (including a business) by a parent to a child.

4. Effective Date Provisions

Several comments were received regarding clarification of the statutory effective date rules.

One comment requested clarification of the effective date of Section 6501(c)(9), as amended. The Taxpayer Relief Act of 1997 provides that the amendments to Section 6501(c)(9) (commencing the running of the period of limitations only if the gift is adequately disclosed) apply to gifts made in calendar years ending after August 5, 1997 (that is, all gifts made in calendar year 1997 and thereafter). However, the underlying legislative history indicates that the amendment to Section 6501(c)(9) applies "to gifts made in calendar years after the date of enactment (August 5, 1997)". H.R. Conf. Rep. No. 220, 105th Cong., Ist Sess. 408 (1997). Notwithstanding this statement in the legislative history, the statutory language is clear that the Section as amended applies to all gifts made during the 1997 calendar year, and thereafter. In the final regulations, the statutory effective date language is restated in a manner that makes it clear that Section 6501(c)(9) as amended applies to all gifts made after December 31, 1996.

Another comment suggested clarification of the application of the adequate disclosure rules and the interaction between Sections 2504(c) and 6501(c)(9) with respect to gifts made between January 1, 1997, and August 6, 1997, since Section 2504(c) as amended applies only to gifts made after August 5, 1997, but Section 6501(c)(9) as amended applies to all gifts made in 1997. In response to this comment, an example has been added under Sec. 25.2504-2(c) involving a situation where a gift is made prior to August 6, 1997, that is not adequately disclosed on the return filed for 1997. The example clarifies that the period for assessment with respect to the pre-August 6, 1997 gift does not commence to run because the gift is not adequately disclosed. Accordingly, a gift tax may be assessed with respect to the gift at any time, and notwithstanding the effective date for Section 2504(c), that 1997 gift can be adjusted as a part of prior taxable gifts in determining subsequent gift tax liability. Further, the 1997 gift can be adjusted as part of taxable gifts under Section 2001 in determining estate tax liability.

Finally, in response to another comment, an example has been added illustrating the application of the effective date rules in a similar fact pattern, where the gifts are made in a calendar year prior to 1997. The example illustrates that the IRS may not revalue the gifts, for purposes of determining prior taxable gifts for gift tax purposes, if a gift tax was paid and assessed with respect to the calendar year, and the period for assessment has expired. Since the gifts were made prior to 1997, the rules of Section 2504(c) and Section 6501 prior to amendment apply. However, the IRS may adjust the gifts for purposes of determining adjusted taxable gifts for estate tax purposes.

DEALER TAX WATCH

INDEX OF ARTICLES: JUNE, 1994 - DECEMBER, 1999

(Continued)

DEALER TAX WATCH

INDEX OF ARTICLES: JUNE, 1994 - DECEMBER, 1999

* ***NOTE:*** To facilitate key word/subject finding:
Certain articles marked (*) are included more than once in the detailed topic/subject listings. Articles relating to IRS Audit manuals, Guides, etc., and ***PRACTICE GUIDES*** (identified by *PG*) are included in the detailed topic/subject listings and in the above ***FINDING LISTS***.
(Rev. January, 2000)

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Notes:

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De Filipps' DEALER TAX WATCH
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

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