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Common Gift Tax Return Mistakes and Ways to Avoid Them

Service

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Over the past few years, an unprecedented number of taxpayers have been taking advantage of the historically high estate, gift, and generation-skipping transfer tax (GST tax) exemptions—currently $12.92 million for 2023 or $12.06 million in 2022—by making more lifetime gifts.

Gifts that exceed the annual exclusion amount—currently $17,000 for 2023 or $16,000 in 2022—are subject to federal gift tax and GST tax, which must be reported on a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. For gifts made in 2022, the return must be filed by April 18, 2023, unless extended to October 16, 2023.

While gift tax returns may appear simple on their face, it is easy to fall into a trap that could have significant tax consequences for the donor. The following is a list of common mistakes and recommendations for ways to address and avoid them.

Reporting Gifts on the Wrong Part of Schedule A

The key to completing Schedule A of a gift tax return correctly is determining whether the donee (the gift recipient) is considered a “skip person” with respect to the donor. A skip person is someone who is two or more generations younger than the donor, generally the donor’s grandchildren (or great-grandchildren), grandnieces, and grandnephews or unrelated individuals, who are more than thirty-seven and a half years younger than the donor.

Gifts to a non-skip person are subject to gift tax but not GST tax and should be reported on Part 1 of Schedule A. Gifts to a skip person (also known as a “direct skip”) are subject to both gift tax and GST tax and should be reported on Part 2 of Schedule A. Part 3 of Schedule A is for gifts to a trust that may include both skip and non-skip beneficiaries (also known as an “indirect

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skip"). Preparers should take care to report gifts on the right part of Schedule A, as this can affect the accuracy of other schedules.

Failure to Properly Account for Prior Gifts

It is important to review the donor's previously filed gift tax returns to verify that all prior gifts have been properly recorded on Schedule B of the current return. This step is crucial for reporting purposes and also necessary for determining how much of the donor's lifetime exemption amount is still remaining. It should also be confirmed that GST elections and annual exclusions were applied correctly in the past.

Even if the donor has never filed a gift tax return before, the preparer should double check whether the donor made any prior gifts in excess of the annual exclusion amount. The preparer should consider whether it is necessary to prepare or amend any prior year returns to resolve past issues and avoid filing the current return with potential inaccuracies.

Forgetting to Include Charitable Gifts

Whenever a donor is required to file a gift tax return for the purpose of reporting taxable gifts, he or she must also report all charitable gifts made during the applicable tax year. This requirement is specifically stated in the Form 709 instructions; however, it is often overlooked because gifts to charity are not subject to gift tax.

Depending on the relative value of any unreported gifts, a failure to report charitable gifts could subject other taxable gifts that were made during the same tax year to IRS review, even after the statute of limitations period has expired.

Failure to Properly Disclose and Support Valuation Discounts

If the donor made any gifts that are subject to a valuation discount, such as a discount for lack of control or lack of marketability, the gift tax return preparer must check the "yes" box on line A at the top of Schedule A and attach support for the valuation to the return—consistent with Treasury Regulations § 301.6501(c)-1(e) and (f). The support should include a qualified appraisal, or a detailed description of the method used to determine the fair market value of the gift, which should explain the discount claimed as well as the amount and the basis for the discount.

Gifts subject to a discount are reviewed very closely and often audited by the IRS. For this reason, it is important to ensure that your support will stand up to tough scrutiny or risk a possible revaluation of the gift by the IRS.

Misapplication of 529 Plan Elections

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A donor who makes a lump-sum transfer in excess of the gift tax annual exclusion amount to a 529 college savings plan has the option of treating up to five times the annual exclusion—currently $85,000 for 2023 or $80,000 in 2022—as if it was paid ratably over a five-year period. This enables the donor to apply the annual exclusion to a portion of the contributed amount for each of the five years.

In order to take advantage of this, the preparer must make a proper election by checking the box on line B at the top of Schedule A in the same year as the contribution was made. The preparer must also attach an explanation which includes: (i) the total amount contributed per individual beneficiary, (ii) the amount for which the election is being made, and (iii) the name of the individual for whom the contribution was made. For each of the five years, one-fifth or twenty percent of the amount subject to the election should be reported on a gift tax return, unless there were no other taxable gifts to necessitate a filing.

Improper GST Allocation and Use of Elections

The automatic GST allocation rules under IRC § 2632(c) are another common source for mistakes on a gift tax return. This type of error can result in a waste of the donor's valuable GST exemption and carry severe tax implications for future generations. For transfers to a GST trust (as defined under IRC § 2632(c)(3)(B)), a donor has the option to either let the automatic GST allocation rules apply, or he or she may choose to elect out of the automatic allocation. To elect out of automatic GST allocation, the preparer must check the box in Column C of Part 2 or Part 3 of Schedule A and attach an appropriate election statement to the return. Even if the automatic allocation is to apply, it may also be prudent to attach an affirmative statement that automatic GST allocation *should* apply to a specific trust, to ensure its proper treatment as a GST trust under the applicable rules. GST exemption that is automatically allocated to an indirect skip should be included on Part 2, line 5 of Schedule D of the return.

As previously stated, it is critical to review the GST elections made for a particular trust on any previously filed gift tax returns, as those elections will affect the current year's transfers to the trust. Inconsistencies can cause the trust to have a mixed inclusion ratio, resulting in only part of the trust being GST exempt.

Inadequate Disclosure of Gifts

When a gift is adequately disclosed on a gift tax return, the IRS can't audit the return or revalue the gift after the three-year statute of limitations period has expired. Treasury Regulations § 301.6501(c)-1(e) and (f) set forth the requirements for satisfying adequate disclosure. In general, the gift should be described with sufficient detail for the IRS to identify the donated property, the recipient of the gift and their relationship to the donor, any trusts that may be involved in the transfer, and how the value

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of the gift was determined. If these criteria have not been satisfied, the IRS has a right to challenge the gift indefinitely.

In many cases, it may be prudent to consider reporting sales between related parties on a gift tax return. Even though the sale would be characterized as a non-gift transaction, the statute of limitations will begin to run on the IRS's right to dispute the valuation of an adequately disclosed sale, and ultimately restrict the IRS's ability to question whether part of the sale is actually a gift due to the sale price or other factors.

Not Confirming Support for Annual Exclusion Gifts to a Trust

In order to qualify a gift to a trust for the gift tax annual exclusion, the gift must be considered a present interest, meaning the beneficiaries of the trust have a right to immediate use of the property. To meet this requirement, beneficiaries are often given what is referred to as a Crummey withdrawal right under the trust terms. The Crummey power allows a beneficiary to withdraw a portion of the donor's contribution to the trust up to a specific dollar amount for a certain period of time.

Trust beneficiaries must receive a Crummey notice in writing to ensure the donor's transfer will qualify for the annual exclusion. Crummey notices are often requested during an audit, so it is a good practice to review and verify that the notices were sent before applying the exclusion on a gift tax return.

Contact us

When it comes to preparing gift tax returns, these common mistakes and others can have major tax consequences. For assistance with preparing or reviewing gift tax returns, please contact a member of the Husch Blackwell Private Wealth Team.

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