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Adequate Disclosure of Gifts

The expiration of the "Bush Tax Cuts" at the end of 2012 created significant uncertainty regarding future exemption levels for gift and estate taxes, resulting in a flurry of estate planning activity at the end of 2012. Legislation passed at the end of the year ultimately increased these exemption levels in 2013, and taxpayers have responded by continuing to use various estate planning techniques to minimize their tax liability and take advantage of higher exemption levels. However, the benefits of estate planning can be jeopardized if a gift is not properly reported.

What is Adequate Disclosure?

Adequate disclosure addresses the issues of what was gifted and how value was determined. The taxpayer can either attach a statement to the gift tax return addressing these issues (see IRC Section 301.6501-1(f)(2)), or they can be addressed in the business valuation report (see IRC Section 301.6501-1(f)(3)). The specifics of the disclosure are included in the code sections listed above, but, in general, cover the following items:

- The appraiser is QUALIFIED to appraise the property and is INDEPENDENT of the donor and donee.
- The property being valued is identified and the valuation methods employed are stated and supported with data to allow another person to replicate the analysis.
- The specifics of the gift are detailed, including the identity of the donor and donee and their relationship to each other.

The independence standard disqualifies the business owner from providing his or her own fair market value. A qualified appraiser passes the independence test while also adhering to specific professional standards (such as USPAP or those of their credentialing organization) that help ensure that the valuation methods are properly performed and documented.

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Why is Adequate Disclosure Important?

Once a gift is made, the IRS may challenge the valuation. If the adequate disclosure rules are satisfied, then there is a time limit of three years on the revaluation of the gift. In general, the less time available to review a gift, the less likely that the gift will be challenged. Also, once the three year period passes, the taxpayer has the peace of mind that the process is complete.

Apart from timing, following the adequate disclosure provisions may also reduce the likelihood of a challenge - especially regarding the application and documentation of the valuation analysis. When the valuation report clearly explains the methodology and the rationale behind the conclusion on value, and proactively addresses issues that the IRS might otherwise take issue with, there should be less of an inclination to challenge the value. This may not always be the case, but a well-documented report that complies with appraisal standards is more credible than one that does not explain the methodologies utilized or is riddled with numerous small errors.

Who Should Care?

The lifetime exemption for gifts at the federal level was $5.12 million in 2012 and is $5.25 million in 2013. Form 709 must be filed to report how much of the lifetime exemption has been used or calculate the amount of tax due.

Smaller gifts are also subject to reporting and, therefore, disclosure requirements. The annual exclusion amount was $13,000 in 2012 and is $14,000 in 2013. This is the amount that can be gifted to multiple people each year without reducing the remaining lifetime exemption amount.

Although the stakes on a single small gift may not seem that high, remember that gifts can be made to multiple people. Also, a lump sum deposit of up to five times the annual exclusion can be made per person (although this restricts gifting in subsequent years). Finally, married couples have separate gift limits, enabling each spouse to take advantage of the annual exclusion amount.

Conclusion

Full and adequate disclosure of gifts is essential to starting the statute of limitations running and also enhances the credibility of the valuation analysis.

Using a qualified appraiser helps to satisfy these disclosure requirements, providing peace of mind to the taxpayer and his or her other professional advisors.

About the Author

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Nick is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and has more than 20 years of experience in valuation, finance, and banking.

He serves on the Valuation Advisory Committee of The ESOP Association and is Co-chair of the Membership Committee of its Ohio/Kentucky Chapter. Nick has been a presenter on valuation topics for The ESOP Association, National Center for Employee Ownership (NCEO), Ohio Employee Ownership Center (OEOC), Southwest Ohio Tax Institute, the North Carolina Bar Association and Lorman Education Services. He has provided valuation training and judging for the Association for Corporate Growth's ACG Cup competition. Additionally, he has presented a full-day seminar on business valuation for the American Society of Appraisers.

Nick earned a Bachelor of Business Administration in Finance and Real Estate from the University of Cincinnati and an MBA from Xavier University.