GIFT TAX RETURNS: FINDING AND FIXING PROBLEMS

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CHAPTER 12

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GIFT TAX RETURNS: FINDING AND FIXING PROBLEMS

I. INTRODUCTION

The vast majority of (if not all) estate planning lawyers or other tax advisors who represent clients with respect to estate planning matters will undoubtedly have at least one client who has made one or more taxable gifts but has failed to file a gift tax return or has filed a gift tax return containing errors. As such, it is important for the advisor to know when a gift tax return must be filed and how to spot errors made in a gift tax return. After an error is discovered, the advisor must know his or her duties to help the client correct the error. This paper will first discuss the circumstances in which a gift tax return must be filed. The paper will then discuss common errors found in gift tax returns. Finally, this paper will discuss what duty an advisor has to inquire into the client's gifting history and to advise the client to file a gift tax return or amend an erroneous gift tax return.

II. CIRCUMSTANCES IN WHICH GIFT TAX RETURN MUST BE FILED

The Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, provide that a citizen or resident of the United States must file a gift tax return whether or not any tax is due if one of the following transfers was made:

- A gift of a present interest in an amount greater than the gift tax annual exclusion under Internal Revenue Code section 2503(b) ($14,000 per donor, per donee in 2015), <u>unless</u> such gift:

  (i) was to the donor's spouse (unless that gift was a terminable interest other than a life estate with the spouse's unlimited power to appoint the entire interest in all circumstances or unless the donor's spouse is not a U.S. citizen and the total gifts made to such spouse during the year exceeded $145,000 in 2015); or

  (ii) was a transfer to a political organization, payment that qualified for the educational exclusion, or payment that qualified for the medical exclusion.

- A gift of a future interest regardless of the amount of the gift.
- A gift of a partial interest to charity or split-interest gift conveying a lead or remainder interest to charity such as a charitable remainder trust or charitable lead trust.
- A gift to the donor's spouse if the gift was of a terminable interest (other than a life estate with the spouse's unlimited power to appoint the entire interest in all circumstances). The donor must file a gift tax return to make the qualified terminable interest property (QTIP) election in order to qualify the gift for the marital deduction, if applicable.
- A gift to the donor's spouse if the donor's spouse was not a U.S. citizen and the total gifts made to such spouse during the year exceeded $145,000 in 2015.

Pursuant to section 6075 of the Internal Revenue Code, a gift tax return generally is due no later than April 15 of the year after a gift was made, but the due date for filing the return may be extended by six months.[1] Notwithstanding the foregoing, the due date for filing a gift tax return may be earlier than April 15 if the donor died and the donor's estate tax return (with extensions) is due prior to April 15 (or the extended due date of the gift tax return, if applicable).[2]

The due date for filing a donor's gift tax return may be extended by the donor extending the time in which to file the donor's income tax return or by filing Form 8892, Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax. Section 6075(b)(2) of the Internal Revenue Code provides that any extension of time granted to the donor for the filing of the donor's income tax return "shall be deemed to be also an extension of time granted" to the taxpayer for filing the donor's gift tax return.[3] If the donor's income tax return is not extended, the donor may file Form 8892 to request an automatic six-month extension of time in which to file the gift tax return.[4] The extension of time in which to file a gift tax return does not extend the time to pay the gift or generation-skipping transfer ("GST") taxes.[5]

III. COMMON ERRORS FOUND IN GIFT TAX RETURNS

A. Gift-Splitting

Federal gift tax law permits gifts made by only one spouse to a third party to be considered for gift tax purposes as being made one-half by the donor spouse and one-half by the nondonor spouse if the spouses were married <u>at the time</u> the gift was made and neither remarried during the remainder of the calendar year and if both spouses were citizens or residents of the United States.[6] Both spouses must consent to splitting any gifts; however, under certain circumstances, only

[1] I.R.C. § 6075(b)(1), (2).
[2] *Id.* § 6075(b)(3).
[3] *Id.* § 6075(b)(2).
[4] Treas. Reg. § 25.6081-1(a), (b).
[5] *Id.* § 25.6081-1(c).
[6] I.R.C. § 2513.

the donor spouse may be required to file a gift tax return.

Once an election has been made to split gifts, the election is irrevocable unless the election is revoked prior to the due date of the gift tax return (including extensions).[7] Likewise, if either spouse files a gift tax return and the election to split gifts is not made, the election may not be made after the due date for filing the return has passed.[8]

"If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return."[9] Thus, as a general rule, community property should not be split.

Community property gifts should only be split if any gifts of separate property were made and the spouses wish to split the separate property gifts. The reason for this is because, if spouses elect to split any gifts, the election will apply to <u>all gifts</u> made by either spouse during the calendar year other than any gift which is not eligible for gift-splitting.[10] A spouse does not have the ability to pick and choose to have certain gifts split while not splitting other gifts.

Gifts that are not eligible for gift-splitting include gifts of property by a donor spouse to a third party if the nondonor spouse has a general power of appointment over such property. In addition, if a donor spouse makes a gift of property to a trust of which the nondonor spouse is a beneficiary, a portion of the gift may not be eligible for gift-splitting.[11] In that event, the "consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to [the nondonor] spouse."[12] The portion of the gift allocated to a third-party is eligible for gift-splitting, but the portion allocated to the nondonor spouse is not eligible. If the gift to the third party cannot be ascertained, then none of the gift qualifies for gift-splitting.[13]

If a client provides the tax advisor with a gift tax return wherein the client and his or her spouse has split gifts, the advisor should review the return to ensure that the gifts were properly split. It is not uncommon for the advisor to find that the donor has split some gifts but not others or to find that the donor has split a gift to a trust of which the donor's spouse is a beneficiary.

B. Exclusion from GST Tax

A donor may make a gift to any donee of an amount up to $14,000 in 2015 without that amount being subject to gift tax or requiring the filing of a gift tax return.[14] This amount is referred to as the "gift tax annual exclusion."

The gift tax annual exclusion is available for a gift of a present interest.[15] The Treasury Regulations define a "present interest" in property as an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."[16] Most gifts in trust will not qualify for the annual exclusion because a gift in trust is generally considered to be a gift of a future interest in property. However, a gift to a trust that meets the qualifications under 2503(c) of the Internal Revenue Code will qualify for the annual exclusion,[17] and a gift to a trust with respect to which a trust beneficiary has the power of withdrawal (i.e., a *Crummey* power) may qualify for the annual exclusion.[18]

The fact that a gift will qualify for the annual exclusion for gift tax purposes does not mean that the gift will qualify for the so-called "GST annual exclusion". However, this fact is lost upon some tax return preparers who assume that if a gift to a trust qualifies for the gift tax annual exclusion, the allocation of GST exemption is unnecessary.

Generally, a direct skip that is a nontaxable gift will have an inclusion ratio of zero (i.e., the direct skip is excluded from the GST tax without the donor having to allocate GST exemption).[19] However, an exception exists if the gift is made to a trust unless (i) during the life of an individual, no portion of the trust property

[7] I.R.C. § 2513(c); Treas. Reg. § 25.2513-3.
[8] I.R.C. § 2513(b); Treas. Reg. § 25.2513-2.
[9] Instructions for 2014 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.
[10] Treas. Reg. § 25.2513-1(b).
[11] *Id.*
[12] *Id.*
[13] *See* Rev. Rul. 56-439, 1956-2 C.B. 605 (ruling that a gift to a trust for the benefit of the donor's spouse, descendants, and spouses of descendants was not eligible for gift-splitting because the trustee's authority to make distributions in his sole discretion resulted in the value of the wife's interest being insusceptible of determination); *Wang v. Commissioner*, 31 T.C.M. (CCH) 719 (1972) (holding that the gift in trust for the donor's spouse did not qualify for gift-splitting because the distributions to the spouse were not limited by an ascertainable standard); *but see Robertson v. Commissioner*, 26 T.C. 246 (1956) (holding that a gift to a trust for the benefit of the nondonor spouse qualified for gift-splitting because the nondonor spouse's interest could be valued when there was no likelihood that the trustee would actually exercise the power to distribute principal when the trustee's distribution power was limited to an ascertainable standard and the trustee was required to take into account other sources of funds); Priv. Ltr. Rul. 200345038 (July 28, 2003).
[14] I.R.C. § 2503.
[15] *Id.*
[16] Treas. Reg. § 25.2503-3(b).
[17] I.R.C. 2503(c).
[18] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).
[19] I.R.C. § 2642(c).

may be distributed to or for the benefit of any person other than such individual (i.e., the trust can have only one current beneficiary), and (ii) the assets of such trust will be included in the gross estate of such individual if the trust does not terminate before the individual dies (e.g., the assets are distributed to the individual's estate upon termination of the trust or the beneficiary has a general power of appointment).[20]

Most trusts that meet the qualifications under section 2503(c) of the Internal Revenue Code should qualify for the GST annual exclusion. However, most other trusts (e.g., irrevocable life insurance trusts) likely will not qualify for the GST annual exclusion even though a gift made to the trust qualifies for the gift tax annual exclusion. Therefore, whenever a tax advisor identifies that his or her client has made gifts to a trust which contains a Crummey withdrawal power (specifically including an irrevocable life insurance trust), the advisor should ask for copies of the client's gift tax returns to ensure that the allocation of GST exemption has been properly reported.

C. Deemed Allocation of GST Exemption

In 2001, Congress enacted section 2632(c) of the Internal Revenue Code. Section 2632(c) of the Internal Revenue Code provides that if a donor makes an indirect skip during such donor's lifetime, any unused portion of such donor's GST exemption will be automatically allocated to the transferred property to the extent necessary to make the inclusion ratio for such property zero. An "indirect skip" is defined as any transfer of property (other than a direct skip) to a GST trust.[21]

The enactment of section 2632(c) was intended to be helpful to donors who wished to allocate GST exemption to a transfer but failed to do so because, for example, the donor's "advisor inadvertently omitted making the election on a timely-filed gift tax return or submitted a defective election."[22] Congress intended for the automatic allocation of GST exemption to apply to transfers to any trust from which a generation-skipping transfer would be likely to occur;[23] therefore, Congress broadly defined the term "GST trust".

A GST trust is defined as a trust that <u>could</u> have a generation-skipping transfer unless one of the six exceptions listed under section 2632(c)(3)(B) of the Internal Revenue Code applies or unless the donor has elected to opt out of the deemed allocation rules.[24] A donor may elect to treat a trust as a GST trust regardless of whether such trust would otherwise qualify as a GST trust.[25]

Because the definition of a GST trust is very broad, it encompasses trusts that are not intended to be GST trusts. The definition is complex and, in some cases, ambiguous. As a result, many tax advisors agree that the deemed allocation rules should not be relied upon in determining whether GST exemption should be allocated to indirect skips.[26] However, not all tax return preparers adhere to this advice. Instead, an advisor may find himself or herself faced with reviewing a client's gift tax return which reports gifts to a trust but does not affirmatively allocate GST exemption. Thus, the advisor must determine whether the deemed allocation rules apply.

(1) The first exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that more than 25% of the trust property must be distributed to or may be withdrawn by at least one individual who is a non-skip person (i) before such individual attains 46 years of age, (ii) on or before one or more dates specified in the trust agreement that will occur before the date that such individual attains 46 years of age, or (iii) upon the occurrence of an event that, in accordance with Treasury Regulations, may reasonably be expected to occur before the date that such individual attains age 46.[27]

(2) The second exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that more than 25% of the trust property must be distributed to or may be withdrawn by at least one individual who is a non-skip person and who is living on the date of death of another person identified in the trust agreement (by name or by class) who is more than 10 years older than such individual.[28]

(3) The third exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that, if at least one individual who is a non-skip person dies on or before a date or event described in section 2632(c)(3)(B)(i) or (ii) of the Internal Revenue Code (i.e., the first exception or the second exception described above), more than 25% of the trust property either must be distributed to the estate of such

[20] *Id*. § 2642(c)(2).
[21] *Id*. § 2632(c)(3)(A).
[22] H.R. Rep't No. 107-37, 107th Cong., 1st Sess., at p. 35 (Apr. 3, 2001).
[23] *Id.*
[24] I.R.C. § 2632(c)(3), (5).
[25] *Id*. § 2632(c)(5).
[26] *See e.g.,* Steve R. Akers, *Estate Planning: Current Developments and Hot Topics*, Est. Plan. for the Fam. Bus. Owner ALI-CLE 217, 237 (July 10-12, 2013) ("Do not rely on automatic allocations of GST exemption[.]" (summarizing point made by Carol Harrington during presentation at 47th Annual Philip E. Heckerling Institute on Estate Planning)).
[27] I.R.C. § 2632(c)(3)(B)(i).
[28] *Id*. § 2632(c)(3)(B)(ii).

individual or is subject to a general power of appointment exercisable by such individual.[29]

(4) The fourth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.[30]

(5) The fifth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that charitable lead annuity trusts (CLATs), charitable remainder annuity trusts (CRATs), and charitable remainder unitrusts (CRUTs) are not GST trusts.[31]

(6) The sixth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a charitable lead unitrust (CLUT) for which a charitable deduction was allowed is not a GST trust if the trust requires the principal to be paid to a non-skip person if such person is alive at the end of the trust term.[32]

Despite the six exceptions to the definition of "GST trust" under section 2632(c)(3)(B) of the Internal Revenue Code, there is an important exception to those exceptions which provides that the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) of the Internal Revenue Code (i.e., the gift tax annual exclusion amount) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.[33] In other words, if a non-skip person has the power to withdraw an amount equal to or less than the gift tax annual exclusion, the trust may qualify as a GST trust. This so-called *Crummey* exception exists so that trusts containing *Crummey* withdrawal powers may fall within the definition of a GST Trust.

The fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code and the *Crummey* exception can wreak havoc on a tax return preparer who relies on the deemed allocation rules. The fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code can be problematic with respect to trusts that contain contingent or formulaic general powers of appointment, and the *Crummey* exception can be problematic with respect to trusts that contain hanging *Crummey* withdrawal powers.

[29] *Id.* § 2632(c)(3)(B)(iii).

[30] *Id.* § 2632(c)(3)(B)(iv).

[31] *Id.* § 2632(c)(3)(B)(v).

[32] *Id.* § 2632(c)(3)(B)(vi).

[33] *Id.* § 2632(c)(3)(B).

1. <u>Contingent General Power of Appointment</u>

As previously stated, the fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code generally causes a trust to fail to be a GST trust at the time of a transfer to the trust if any portion of the trust would be included in the gross estate of a non-skip person if such person had died immediately after such transfer. In other words, assuming the *Crummey* exception is not applicable, if a non-skip person would have a general power of appointment over the trust property if he or she had died immediately after the transfer, then the trust will not be a GST trust.

Many trust agreements provide a contingent general power of appointment that would allow a non-skip person to have a general power of appointment only if the inclusion ratio of the trust is greater than zero immediately prior to such non-skip person's death. Such a contingent general power of appointment creates the following circular analysis:

- Does a non-skip person have a general power of appointment? It depends on whether the deemed allocation rules apply. If the deemed allocation rules apply, the inclusion ratio would be zero and the non-skip person would not have a general power of appointment. This would result in the trust being a GST trust.
- Do the deemed allocation rules apply? It depends on whether a non-skip person has a general power of appointment. If there is no general power of appointment, then the assets of the trust would not be included in the non-skip person's estate and the deemed allocation rules would apply. This would result in the trust being a GST trust.

This circular analysis has resulted in an unclear answer as to whether the deemed allocation rules apply to a trust which gives a non-skip person a contingent general power of appointment. At least one pair of commentators believe that the deemed allocation rules would not apply to a trust in which a non-skip person has a general power of appointment which is contingent on the trust's inclusion ratio being greater than zero. Such commentators state that "it would seem that since the transferor always has the option of electing out of any deemed allocation . . . it should be assumed that there will not be a deemed allocation, with the result that a testamentary general power in the non-skip person will be assumed to exist immediately after the gift."[34] However, there arguably is no basis to assume that a donor would opt out of the deemed allocation rules with respect to a trust which has a contingent general power of appointment. Because the

[34] Thomas E. Peckham and Harry F. Lee, *The GST Tax and Various Planning Issues*, Post-Mortem Plan. & Est. Admin. ALI-CLE (March 2007).

deemed allocation rules allocate GST exemption at the time of the transfer, an argument could be made that the deemed allocation rules cause GST exemption to be retroactively allocated as of the date of the transfer unless the donor affirmatively opts out of the rules. In that case, the beneficiary would not have a general power of appointment and the deemed allocation rules should apply.

In the author's experience, there are many tax return preparers who (erroneously) assume that because a trust is intended to be exempt from the GST tax, the deemed allocation rules apply, and no thought is given to what consequence the contingent general power of appointment may have on the deemed allocation rules.

2. Formulaic General Power of Appointment

Some trust agreements provide that a non-skip person has a general power of appointment only *if* the estate inclusion would result in a lower aggregate tax than if the property were subject to the GST tax and only *with respect to* the portion of the property that would result in a lower tax. If such a formula general power of appointment is given, it may be difficult (or impossible) to determine whether a non-skip person would have a general power of appointment if he or she died immediately after the transfer to a trust is made.

If a non-skip person has a formula general power of appointment over a trust, then in order to determine whether such non-skip person would have a general power of appointment, and thus whether such a trust is a GST trust, the tax return preparer may have to perform an in depth analysis of the non-skip person's estate to compare the tax resulting from having a general power of appointment versus not having a general power of appointment. For example, the tax return preparer may have to review any prior gift tax returns filed by the non-skip person to determine his or her remaining estate tax exemption, determine the value of every asset of such person using values as of the date of the transfer to determine the value of his or her gross estate, and factor in debts and expenses of the non-skip person's hypothetical estate to determine his or her taxable estate. In most cases, it is probable that the tax advisor will not have access to this information in any detail. Even if the information is available, a client likely would not want to pay for the analysis. This is another example of why the deemed allocation rules should not be relied upon, but if a tax advisor is reviewing returns prepared by a tax return preparer who relied on the deemed allocation rules, he or she may have to go through the analysis to determine how much GST exemption the client has available.

3. Hanging *Crummey* Withdrawal Powers

Some trust agreements, in particular irrevocable life insurance trusts, provide that one or more beneficiaries of the trust have a power to withdraw gifts made to the trust. This power of withdrawal is typically limited in some way, but many times a beneficiary will be able to withdraw an amount equal to the gift tax annual exclusion amount so that the donor can maximize the use of his or her gift tax annual exclusion with respect to that beneficiary.

If a beneficiary is given the power to withdraw gifts made to the trust, the withdrawal power typically will lapse at some future point in time (e.g., 30 days or 60 days after the gift is made) so that the beneficiary no longer has the ability to withdraw the gift. The lapse of a withdrawal power can have negative tax consequences to the beneficiary if the amount of the gift that lapses is greater than \$5,000 or 5% of the value of the trust property. A beneficiary's power of withdrawal is considered a general power of appointment;[35] therefore, to the extent that the beneficiary's withdrawal power lapses as to the greater of \$5,000 or 5% of the value of the trust property, the excess portion would be includible in the beneficiary's estate.[36] To avoid a portion of the trust being included in the beneficiary's estate, many trusts will include a "hanging" withdrawal power which provides that the gift in excess of the greater of \$5,000 or 5% of the value of the trust property will not lapse. Instead, the excess amount is carried forward until the power can lapse without there being negative tax consequences for the beneficiary.[37]

If a tax return preparer relies on the deemed allocation rules and gifts are made to a trust containing a hanging withdrawal power, the tax return preparer may have to analyze the trust at each point in time when a withdrawal power lapses or has previously lapsed to determine whether the trust is a GST trust. As previously discussed, the *Crummey* exception provides that the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the gift tax annual exclusion amount, but this *Crummey* exception does not necessarily apply to hanging withdrawal powers. If the amount "hanging" exceeds the annual exclusion amount, the *Crummey* exception will not

[35] I.R.C. §§ 2514, 2041; *see also* Donald O. Jansen, *Giving Birth to, Caring for, and Feeding the Irrevocable Life Insurance Trust*, 41 Real Prop. Prob. & Tr. J. 571, 607 (Fall 2006).
[36] I.R.C. § 2041.
[37] *Id.* § 2041(b)(2).

apply, and the trust will not be a GST trust.[38] As a result, a trust which includes hanging withdrawal powers may be a GST trust in one year and not a GST trust in another year.

To illustrate the conclusion above, assume that a grantor creates a life insurance trust for his one child and that child's descendants. The trust gives the child the power to withdraw gifts made to the trust, and that the withdrawal power is limited to the annual exclusion amount. The withdrawal amount lapses as to the greater of $5,000 or 5% of the value of the trust property 30 days after the date of the gift. In year 1, the grantor makes a gift of $14,000, which is the annual exclusion amount. The *Crummey* exception would apply so that the trust would be a GST trust (assuming that none of the other exceptions to the definition of GST trust would apply). However, if the withdrawal power lapses as to only $5,000, $9,000 would be left hanging. If the grantor makes another gift of $14,000 in year 2, the child will have the power to withdraw $23,000 which is well in excess of the gift tax annual exclusion amount. As a result, the *Crummey* exception will not apply, and the trust will not be a GST trust.

Although best practice is to never rely on the deemed allocation rules, there are far too many tax return preparers who allow the deemed allocation rules to apply. It is especially troublesome to see a tax return preparer rely on the deemed allocation rules when his or her client has made a gift to an insurance trust that contains hanging withdrawal powers because, many times, no analysis is done to determine whether the hanging powers would cause the trust to fail to be a GST trust.

In order to properly analyze whether the trust is a GST trust, it is necessary to determine whether a beneficiary has a withdrawal power over an amount in excess of the gift tax annual exclusion amount. This analysis will require the value of the trust property to be determined each time a withdrawal power lapses (unless the value of the trust property over which the withdrawal power lapses is obvious). If the trust only holds life insurance, it may be necessary to ask the insurance company for the Form 712 to determine the value of the insurance policy. If the trust holds hard-to-value assets, such as partnership interests or closely held stock, it may be necessary to hire a valuation expert to appraise the property. If the time is not taken to determine the value of the trust property on the date a withdrawal power lapses, then at the time a gift is made to the trust it may not be possible to determine the amount subject to a withdrawal power which has lapsed or the amount subject to a withdrawal power which is still hanging.

If GST exemption is affirmatively allocated at the time the gift tax return is filed, this in depth analysis is not required. However, if a tax advisor is reviewing returns that have already been filed or the tax advisor discovers that the client has not been filing gift tax returns, the tax advisor should go through the exercise of determining whether the trust is a GST trust in each year a gift is made so that the tax advisor can determine how much GST exemption the client has remaining.

IV. DUTY OF ADVISOR TO FIND AND FIX PROBLEMS

Tax advisors often wonder whether they have a duty to inquire into a client's gifting history or to review the work of another tax professional. Likewise, tax advisors often wonder what their duty is if it is discovered that the client has failed to properly file gift tax returns or has filed gift tax returns containing errors. These issues are discussed below with respect to lawyers in particular. However, any discussion regarding Treasury Department Circular No. 230 ("Circular 230") also would apply to certified public accountants and other persons representing taxpayers before the Internal Revenue Service.[39] Tax return preparer penalties are beyond the scope of this paper.

A. Duty to Find Tax Return Related Problems

A tax advisor owes a duty to his client, and he or she owes a duty to the tax system.[40] Circular 230 contains rules that govern a lawyer's authority to practice before the Internal Revenue Service, the duties and restrictions relating to such practice, and sanctions for violating Circular 230.[41] Circular 230's reach is broad and encompasses all matters connected with a presentation to the Internal Revenue Service, which may include preparing and filing documents.[42] Circular 230 applies to not only those who prepare tax returns, but also those who assist in preparing tax returns.[43]

A lawyer's duty to his or her client includes acting with reasonable diligence and promptness when representing a client.[44] "Reasonable diligence" is defined as a "fair, proper and due degree of care and activity, measured with reference to the particular

[38] *See also* Julie K. Kwon, *Generation-Skipping Transfer Tax Planning and Update*, Est. Plan. In Depth ALI-CLE (June 2011).

[39] Treas. Dept. Circular No. 230, 31 C.F.R. § 10.0 (Rev. 6-2014).

[40] *See* Kenneth L. Harris, *Ethics in Tax Practice: Emerging Standards for Reporting Tax Return Positions*, William & Marry Annual Tax Conference (1990).

[41] 31 C.F.R. § 10.0.

[42] *Id.* § 10.2(a)(4).

[43] *Id.* § 10.8(a), (c).

[44] ABA Model Rules of Prof'l Conduct R. 1.3.

circumstances; such diligence, care of attention as might be expected from a man of ordinary prudence and activity."[45] A lawyer's duty to the Internal Revenue Service requires a lawyer to exercise due diligence in "preparing or assisting in the preparation of, approving, and filing tax returns . . . ."[46] "Due diligence" is defined as "[s]uch a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case."[47] Thus, in either case, whether a lawyer has acted with a sufficient level of diligence will depend on facts and circumstances.

Whether a lawyer has a duty to inquire into the client's gifting history in exercising reasonable or due diligence depends upon the scope of the representation. For example, if a lawyer's representation of the client is limited to only the preparation of the client's last will and testament and the amount of the client's remaining estate or GST exemptions is irrelevant, then the lawyer may not have a duty to inquire into the client's gifting history. In such case, the answer as to whether the client has made taxable gifts has no bearing on the work product the lawyer produces for the client. Conversely, if the lawyer's representation includes the preparation of a fully tax-planned will or assisting the client in transferring assets out of his or her estate, then the lawyer has a duty to his or her client to determine the client's remaining transfer tax exemptions. Thus, the lawyer necessarily will need to determine whether the client has previously made taxable gifts. If the lawyer's representation includes reviewing or preparing gift tax returns, then the lawyer has a duty to not only the client, but also to the Internal Revenue Service to determine whether the client has previously made taxable gifts.

If a client indicates that he or she has never made taxable gifts and the lawyer has no reason to believe that the client is being untruthful, the lawyer's duty of reasonable or due diligence should be satisfied.[48] However, if the client makes statements to the lawyer which would lead a prudent person to believe that taxable gifts may have been made, the lawyer would be remiss to ignore those statements. Instead, Circular 230 and general prudence would require the lawyer to engage in an additional line of questioning with the client to determine whether the client may have unknowingly (or knowingly) made taxable gifts.[49] For example, if a client indicates in passing that his or her college student child owns a penthouse in Manhattan, the lawyer should ask for additional facts surrounding how the child became the owner of such an expensive residence. If the client then indicates that he or she made the down payment for the child's penthouse, the lawyer should determine whether the client had any intent for the child to repay the client. If not, the lawyer may have discovered a taxable gift. Even if the client intended for the child to repay the client, there may still be taxable gift issues if the loan is considered a below market loan in accordance with section 7872 of the Internal Revenue Code. It may be tempting for the lawyer to bury his or her head in the sand upon hearing facts that may lead to the conclusion that the client has made unreported taxable gifts; however, such inaction would be contrary to the lawyer's duty to his or her client and to the Internal Revenue Service.[50]

If a client indicates that he or she has made taxable gifts and has previously filed gift tax returns, the lawyer should not have a duty of further inquiry unless the lawyer will review or prepare the client's gift tax return. If the lawyer has been engaged to prepare or to assist in preparing the client's gift tax return, the lawyer's duty of due diligence suggests that the lawyer review prior gift tax returns to ensure that there are no blatant errors in the returns (particularly if prior gifts to insurance trusts have been made). Although section 10.22(b) of Circular 230 provides that a practitioner generally will be presumed to have exercised due diligence if the practitioner relies on the work of another person, the practitioner is required to have used reasonable care in engaging, supervising, training, and evaluating the other person.[51] Thus, section 10.22(b) generally will not apply to situations where a lawyer is taking over the gift tax return preparation duties of a tax practitioner outside of his or her firm.

[45] Black's Law Dictionary 457 (6th ed. 1990).

[46] 31 C.F.R. § 10.22(a)(1).

[47] Black's Law Dictionary 457.

[48] 31 C.F.R. § 10.34(d) ("A practitioner . . . preparing or signing a tax return . . . generally may rely in good faith without verification upon information furnished by the client.").

[49] *Id.* ("The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.").

[50] If a tax advisor chooses to not make reasonable inquiries, such negligence could lead to penalties under section 6664 of the Internal Revenue Code. *See* Frederick K. Hoops, Frederick H. Hoops III, and Daniel S. Hoops, 1 Fam. Est. Plan. Guide § 1.15 (4th ed.) ("Ignorance of contrary facts or failure to inquire into the veracity of certain information provided by the taxpayer or another return preparer or interested third party will not vindicate a return preparer's duty of diligence." (citing Treas. Reg. § 1.6664-2(d)).

[51] 31 C.F.R. § 10.22(b).

Circular 230 contains "best practices" for a lawyer. Specifically, section 10.33 of Circular 230 provides:

> Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service.[52]

Best practices include establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations relating the applicable law to the relevant facts, and arriving at a conclusion supported by the law and the facts as well as advising the client regarding the importance of the conclusions reached.[53] Pursuant to Circular 230's best practices, a lawyer should inquire into a client's prior gifting history and should review prior gift tax returns filed to establish relevant facts. The failure to comply with best practices will not subject the lawyer to sanctions under Circular 230, but it may indicate that the lawyer has failed to exercise due diligence as required under section 10.22 of the Treasury Regulations.[54]

B. Duty to File or Amend Return

If a lawyer discovers that his or her client has failed to file a gift tax return which was due or that his or her client has filed a prior gift tax return that contains errors, the lawyer must determine what his or her duty is, if any, to require the client to file a gift tax return or to file an amended return.

Section 10.21 of Circular 230 requires that a lawyer who knows that a client has made an error on or an omission from a return advise the client promptly of (i) the fact of the error or omission and (ii) the consequences of the error.[55] Specifically, Section 10.21 of Circular 230 provides:

> A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.[56]

Further, a Formal Opinion of the American Bar Association provides that the lawyer must not only advise the client of the existence of an error, but must advise the client that the error should be corrected.[57] Specifically, Opinion 314 provides:

> [W]ith regard . . . to the preparation of returns . . . , the lawyer is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, either by misstatements or by silence or by permitting his client to mislead. The difficult problem arises where the client has in fact misled but without the lawyer's knowledge or participation. In that situation, upon discovery of the misrepresentation, the lawyer must advise the client to correct the statement; if the client refuses, the lawyer's obligation depends on all the circumstances.[58]

Thus, a lawyer is obligated to advise the client that the client should file a return upon discovering that taxable gifts were made but gift tax returns were not filed. Further, a lawyer is obligated to advise the client that the client should file an amended tax return upon discovering that a prior return contained an error.

Although the lawyer must advise the client to file a return or an amended return, the client does not have a duty to file an amended tax return upon the discovery of an error. The United States Supreme Court has acknowledged that the Internal Revenue Code does not explicitly provide for a donor's filing, or for the Service's acceptance of, an amended tax return.[59] Rather, an amended tax return is a creature of administrative origin and grace.[60] Based upon the Supreme Court's decision and the lack of any requirements in the Internal Revenue Code or the Treasury Regulations that an amended return be filed to correct prior errors, there does not seem to be any clear authority that stands for the proposition that the

[52] *Id.* § 10.33(a).
[53] *Id.* § 10.33(a)(2).
[54] Michael G. Goller, *Practitioners Take Note: Now is a Good Time for a Circular 230 Refresher*, J. Tax Prac. & Proc. (June-July 2012).
[55] Ian M. Comisky and Michael D. Shepard, *To Amend or Not to Amend? The Wisdom of Correcting Tax Return Errors*, Fla. Bar J., Feb. 1996, at 49.
[56] 31 C.F.R. § 10.21.
[57] ABA Comm. on Prof'l Ethics and Grievances, Formal Op. 314 (1965).
[58] *Id.*
[59] *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984).
[60] *Id.*

donor is under a legal obligation to file an amended return upon the discovery of an error on a previously filed return.[61] It should be permissible for the lawyer to further inform the client that the United States Supreme Court has stated that neither the Internal Revenue Code nor the Treasury Regulations legally requires the filing of an amended return.[62]

If a client should file an amended tax return and refuses to do so, the lawyer does not have a duty per se to withdraw from his representation of that client.[63] The fact that the client is not legally obligated to correct an error in a return suggests that a lawyer should be free to continue to represent the client provided that such representation does not further the error.[64]

A lawyer has a duty to exercise due diligence in the preparation and filing of tax returns and to avoid participating in any way in the giving of false or misleading information.[65] Because of those duties, a lawyer is prohibited from preparing a current tax return in a manner incorporating any prior errors of which the lawyer is aware.[66] Moreover, section 10.34 of Circular 230 provides that a practitioner may not willfully, recklessly, or through gross incompetence sign a tax return that the practitioner knows or reasonably should know contains a position that lacks a reasonable basis.[67] Model Rule 4.1(a) requires that the "lawyer shall not knowingly make a false statement of material fact or law to a third person," and Model Rule 8.4(c) prohibits the lawyer from engaging in fraudulent or dishonest conduct.[68] Thus, Circular 230 and the Model Rules support the conclusion that a lawyer may not complete a tax return when doing so would further a prior error about which the lawyer knows or reasonably should know.[69] Assuming that the lawyer's representation is wholly unrelated to the uncorrected error, Circular 230 and the Model Rules appear to sanction continued representation.[70]

V. CONCLUSION

Generally, a client must file a gift tax return if he or she has made a gift of a present interest in an amount greater than the gift tax annual exclusion amount or a gift of a future interest or under other circumstances outlined in the Instructions for Form 709. If a client has previously filed a gift tax return, the advisor should have the ability to spot errors in such returns.

Common errors found in gift tax returns include gift tax returns which split gifts of community property, split some gifts but not all gifts, or split gifts ineligible for splitting, such as gifts to a trust of which the nondonor spouse is a beneficiary. In addition, another common error found in gift tax returns include gift tax returns which fail to properly allocate GST exemption to gifts because it is erroneously assumed that the GST annual exclusion is applicable or that the deemed allocation rules apply.

If the scope of a lawyer's representation of his or her client is narrow enough, the lawyer may not have a duty to inquire into whether prior gifts have been made and to review gift tax returns previously filed by the client. However, if the lawyer will be preparing or assisting in the preparation of a client's gift tax return, the lawyer has a duty to determine whether the client previously has made taxable gifts and to review the client's prior gift tax returns.

If the lawyer discovers the client has not filed gift tax returns which were due or has filed erroneous gift tax returns, the lawyer must advise the client that the client should file a gift tax return or file an amended gift tax return, as applicable. However, the client is not

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[61] 15 Mertens Law of Fed. Income Tax'n § 56:73; *see also* Ian M. Comisky and Michael D. Shepard, *To Amend or Not to Amend? The Wisdom of Correcting Tax Return Errors*, Fla. Bar J., Feb. 1996, at 49 ("No code provision, however, requires the filing of amended returns."); Kenneth L. Harris, *On Requiring the Correction of Error Under the Federal Tax Law*, 42 Tax Law. 515, 517 (1989) ("A review of the Code and the regulations thus indicates, somewhat surprisingly, that there is no stated requirement that a donor file an amended return on the discovery of an error which results in additional tax due on a prior year's return."); Sheldon D. Pollack, *What Obligations Do Donors and Preparers Have to Correct Errors On Returns?*, 72 J. Tax'n 90, 90 (1990) ("Although the Code and Regulations explain when a donor is permitted to file an amended return, there is no provision requiring the filing of such a return."); John R. Price, Tax Management Portfolio: Conflicts, Confidentiality, and Other Ethical Considerations in Estate Planning, No. 801 ("There is, however, generally no duty to file an amended return."); Judson L. Temple, *Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors*, 76 Neb. L. Rev. 223, 229 (1997) ("The regulations do not, however, impose a duty on donors to file amended returns.").

[62] Comisky & Shepard, *supra*, at 50.

[63] Pollack, *supra*, at 90.

[64] Harris, *supra*, at 526.

[65] 31 C.F.R. §§ 10.22(a), 10.51(d).

[66] Harris, *supra*, at 523-24; *see also* Pollack, *supra*, at 90-91 ("[T]o the extent an attorney advises a client as to the proper method of reporting a position for the tax year at issue, the attorney may not deliberately mislead the Service or permit the client to do so."); *see also* Akers, *supra*, at 237 ("A planner may not have a duty to correct prior returns that were inadvertently incorrect, but a preparer does have a duty not to report a wrong number in this year's return that the preparer knows is incorrect because it does not reflect prior gifts.").

[67] 31 C.F.R. § 10.34.

[68] Model Rules of Prof'l Conduct R. 4.1(a) and 8.4(c).

[69] Harris, *supra*, at 524.

[70] Harris, *supra*, at 526.

legally obligated to correct the error; therefore, the lawyer should not have the duty to withdraw from representation of the client unless such representation would further the error. Nevertheless, a lawyer may not prepare or assist in preparing a gift tax return that furthers an error about which the lawyer knows or reasonably should know.