Estate of Frederick R. Smith, Deceased, Frederick D. Smith and Kay A. Hemingway, Personal Representatives, Petitioner v. Commissioner of Internal Revenue, Respondent, 94 T.C. 872 (1990)

Section 2504(c) of the Internal Revenue Code, which prevents the revaluation of prior gifts for gift tax purposes after the statute of limitations has expired, does not prevent the IRS from revaluing those gifts when calculating adjusted taxable gifts for estate tax purposes under Section 2001(b)(1)(B).

Summary

The Estate of Frederick R. Smith petitioned the Tax Court to contest the Commissioner's revaluation of prior taxable gifts for estate tax purposes. Smith made gifts in 1982, and the statute of limitations for gift tax assessment expired in 1986. Upon Smith's death in 1984, the IRS, in a 1988 notice of deficiency, increased the value of these gifts when calculating "adjusted taxable gifts" for estate tax. The Tax Court held that Section 2504(c) only limits revaluation for gift tax, not estate tax, purposes. The court reasoned that the language of Section 2001(b)(1)(B) and its legislative history do not incorporate the Section 2504(c) limitation. The court also held that the estate is entitled to adjust the "gift taxes payable" under Section 2001(b)(2) to reflect the revalued gifts.

Facts

Decedent Frederick R. Smith gifted shares of stock in 1982 and timely filed a gift tax return, valuing the gifts at approximately $284,000, and paid the gift taxes.

Smith died in 1984, and his estate filed a timely estate tax return in 1985, reporting the gifted stock at the previously reported gift tax value.

The statute of limitations for assessing gift tax on the 1982 gifts expired in 1986.

In 1988, the IRS issued a notice of deficiency for estate tax, revaluing the gifted stock at approximately $668,000 for estate tax purposes, increasing the "adjusted taxable gifts." The IRS did not correspondingly increase the gift tax payable subtraction.

Procedural History

The Estate of Frederick R. Smith petitioned the Tax Court contesting the Commissioner's determination of estate tax deficiency.

The Commissioner moved for partial summary judgment regarding the revaluation of gifts for estate tax purposes.

The Tax Court granted the Commissioner's motion for partial summary judgment, with a qualification regarding the computation of gift taxes payable.

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Issue(s)

1. Whether the IRS is barred by Section 2504(c) and the statute of limitations from revaluing prior taxable gifts when calculating "adjusted taxable gifts" for estate tax purposes under Section 2001(b)(1)(B), when the time to revalue those gifts for gift tax purposes has expired.

2. Whether, if the IRS can revalue prior gifts for estate tax purposes, the estate is entitled to adjust the "gift taxes payable" under Section 2001(b)(2) to reflect the increased value of those gifts.

Holding

1. No. The Tax Court held that Section 2504(c) does not bar the IRS from revaluing prior taxable gifts when calculating "adjusted taxable gifts" for estate tax purposes because Section 2504(c) by its terms applies only to gift tax computations and not estate tax computations.

2. Yes. The Tax Court held that the estate is entitled to have the "gift taxes payable" under Section 2001(b)(2) adjusted to reflect any increase in the value of prior gifts because the statute and legislative history of Section 2001(b)(2) do not limit the gift tax subtraction to the amount of gift taxes originally paid, but rather to the aggregate amount of tax that would have been payable.

Court's Reasoning

The court applied a strict construction to statutes of limitation favoring the government, citing *Badaracco v. Commissioner*, 464 U.S. 386 (1984).

The court noted that Section 2504(c) explicitly limits revaluation of prior gifts "for purposes of computing the tax under this chapter [Chapter 12 – Gift Tax]." The court found no similar limitation in Section 2001 (Chapter 11 – Estate Tax).

The legislative history of Section 2504(c) indicates it was enacted to provide certainty in gift tax calculations, but this purpose does not extend to estate tax calculations.

The court rejected the petitioner's argument that the doctrine of pari materia should apply to incorporate Section 2504(c) into Section 2001, finding no legislative intent or compelling reason for such an incorporation, especially for a statute of limitations provision.

The court acknowledged the practical difficulties for taxpayers in proving gift values many years later but stated that courts cannot rewrite statutes to improve their effects, especially statutes of limitation.

Regarding the "gift taxes payable" subtraction, the court reasoned that Section

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2001(b)(2) uses the phrase “aggregate amount of tax which would have been payable,” not “previously paid.” Legislative history and subsequent amendments indicated Congressional intent to provide a full offset for gift taxes payable, based on the unified rate schedule at death, even if rates changed or gifts were revalued.

The dissenting opinion argued that Section 2001(b) should be interpreted to incorporate the limitations of Chapter 12 in its entirety, including Section 2504(c). The dissent contended that Congress intended a unified system and not to allow revaluation for estate tax when barred for gift tax. The dissent also argued that the majority’s allowance of credit for unpaid gift taxes did not fully offset the increased estate tax from revaluation, as illustrated in the appendix examples.

Practical Implications

Estate of Smith establishes that the IRS can revalue prior taxable gifts for estate tax purposes, even if the statute of limitations has expired for gift tax adjustments. This creates uncertainty for estate planning, as the value of past gifts is not definitively settled for estate tax calculations until the estate tax statute of limitations expires.

Practitioners must advise clients that prior gifts, even with expired gift tax statute of limitations, may be re-examined for estate tax purposes, potentially increasing the estate tax liability.

This case highlights the importance of thorough gift tax valuation and documentation at the time of the gift to defend against potential revaluation upon death. It also suggests that legislative action might be needed to harmonize the gift and estate tax systems regarding valuation finality.

Later cases and rulings have generally followed *Estate of Smith*, reinforcing the IRS’s ability to revalue prior gifts for estate tax purposes. This decision remains a cornerstone in estate tax law regarding the valuation of adjusted taxable gifts.

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