

## DUPAGE COUNTY ESTATE PLANNING COUNCIL

### HANDLING AN ESTATE TAX AUDIT

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McDermott Will & Emery LLP

#### I. Introduction

- A. Illinois Estate - Filing for Illinois Estate Tax Audit, also,
- B. Recent IRS Audit Census
- C. Topics Outline

II. Audit Avoidance - Preparation of Return

III. FET Review Process

IV. Audit Conference

V. Executor Duties and Liability Exposure

VI. Closing Audit and Review Process

#### II. Audit Avoidance - Preparation of Return

A. Start with accurate use of IRS forms

1. All information required on face of 706 and its instructions must be submitted to comply with I.R.C. §§6011 and 6018

a. Remove nonissues - Establish credibility with small items -- personal property 709, 1040 review, bank account records, safe deposit box info.

B. Review of “Red Flag” items

1. Information section, pp 1-3 of Return

2. New questions regarding Trusts and asset sales

C. Do not ignore background information sections -- agents read carefully to see consistency between decedent’s profession and assets

1. Executive - benefit plans

2. College professor - royalties and copyrights

3. "Grid" of Distribution (GST and 1041 issues)
4. Elections
  - a. Alternate valuation - available only if less tax
  - b. §6166 - follow format outlined in regulations
5. Schedule A
  - a. §2032A - election
  - b. Include appraisals
6. Schedule B
  - a. Accrued bond interest and stock dividends; large diversified portfolio should have these (see 1040); ex-dividend
  - b. Discounts for blockage, marketability, minority interest
  - c. To give or not to give financial records for past five years for closely held stock
7. Schedule C
  - a. See 1040
  - b. Accrued interest
  - c. Notes -- discounts again are troublesome; demand note -- no discount; noncollectible issue; notes among family members
8. Schedule D
  - a. Nonincluded insurance -- if owned by company, should be included in Company valuation; buy-sell agreements
9. Schedule E
  - a. Hidden gifts -- other owners to be identified
  - b. IRS may challenge non-spousal joint tenancies where contribution is argued
  - c. Gallenstein issues
10. Schedule F

- a. Refunds; medical insurance; crops; jewelry; household goods
  - (1) credibility schedule
- 11. Schedule G
  - a. Do not lump trust assets to determine value
  - b. Gift tax includible - 3 years from gift, not payment
- 12. Schedule H
  - a. Custodian for accounts of minors to whom one owes an obligation of support
  - b. Be careful to describe instruments creating powers thoroughly and why you believe property not includible (pre 10/21/42)
- 13. Schedule I
  - a. Pre 1984 Grandfather exclusion
- 14. Schedules J, K, L - ordinarily and necessarily incurred
  - a. Consistency with asset schedules (one-half exclusion assets deduct expenses at one-half)
  - b. Deductions for appraisals not submitted may indicate appraisal shopping
  - c. Challenge of Fees: White 650 F. Supp 904 (DCNY 1987) - Significant audit issues - IRS not bound by state court determination of reasonableness
  - d. Claims
    - (1) Family members or legatees
    - (2) Contested?
    - (3) Consideration
  - e. Estimated expenses - unincurred expenses
- 15. Other issues
  - a. Gift Problems
    - (1) Estate of Sachs, 88 TC 769

- (2) Gifts by power of attorney (durable?), by guardian (substituted judgment or planning statute recognized by state law?)
- (3) Prior transfer of shares or assets -- business financial information does not match up with gift tax returns; funding of trust does not match up with gift returns
- (4) Premium payment on the insurance policy gifted during life
- (5) Reciprocal gifts from siblings to nephews and nieces; Rev. Rul. 85-24, 1985-1 CB 329
- (6) Loans
- (7) When do gift problems go away? Statute of limitations -- §6501
  - (A) No gift tax return filed -- no limitation on when tax may be assessed §6501(c) (3)
  - (B) Gift tax return filed -- three-year rule -- §6501(a)
  - (C) Boatmen's 1st Natl Bank of K.C. vs. USA - IRS tried to revalue gifts on tax returns where tax had been assessed and paid and statute had run for purposes of calculating gift tax. Western Div. of Missouri D.C. rejected argument saying it would not allow IRS to recalculate value of gifts and thus have a second shot at taxing such gifts at the estate tax level
  - (D) New regulatory carve out in §6501(c)(a) for return due after August 5, 1997 -- "gifts not shown on return."
- (8) Hidden gifts -- Rev. Rul. 84-11, 1984-1 C.B. 201; Rev. Rul. 83-120, 1983-2 C.B. 170; §2504

16. Exposure

- a. Tax increase
- b. Interest computation
- c. Penalty potential
- d. Recovery issues, §§(2207B); 2044

### III. FET Review Process

- A. Service Center - now filed in Cincinnati
  - 1. Math checked; gift tax returns verified
  - 2. Forward return to Classification
- B. Classification -- Estate Tax Attorney (ETA) (Floaters)
  - 1. Reviews several FETs per hour for issues with tax potential; sort returns into those which are acceptable and those which are to be sent to District for further review
  - 2. If on review, return acceptable, ETA will either:
    - a. Send closing letter; or,
    - b. Ask for state death tax credit evidence and on receipt, will send closing letter
  - 3. What distinguishes return for forwarding to District for examination:
    - a. Needs of District
    - b. Size of estate
    - c. Other "census" issues
      - (1) Name of preparer
      - (2) Targeted estate assets or deductions
      - (3) Missing substantiating data or other information required by instructions or form
      - (4) Family Entity Planning
- C. District Office -- Managing Attorney will either:
  - 1. Survey before assignment (lack of audit or staff potential)
  - 2. Hold for future consideration
  - 3. Assign immediately to ETA (examiner)

- D. The assigned ETA may:
1. “Survey after assignment” for lack of potential -- no or minimal report; no review; issuance of closing letter by District
  2. Make preliminary investigation without contacting taxpayer (i.e., review probate or state tax file, view property, talk with experts, review 1040, 1041 and deeds)
  3. Contact taxpayer which will require at closing a formal review and chance review by review staff

IV. Audit Conference

A. Waiting for the agent

1. Clients become impatient as district office now takes months or in some cases years to perform initial examination
2. Not advisable to contact District Office to examine status of return, because returns do fall between the cracks, or you may generate special scrutiny in a case that would otherwise have been ignored

B. Initial information request

1. May be a handwritten letter, usually will contain a substantial “laundry list” of information and documents requested. Scope varies substantially depending on particular agent; may try to narrow scope but only where excessive
2. Will almost always contain initial request for power of attorney and fee affidavit
3. Some agents will refuse anything other than brief, formal phone contact prior to receiving power of attorney
4. May rely on designation of agent or Form 706
5. Until agent has power of attorney, he is free to contact your client and some agents will do this. Conversely, you cannot direct agent not to contact client until he or she has power of attorney.
6. Power of attorney should include not only 706 matters but any 709, any 1041 and last three years’ 1040

C. Initial response to agent

1. Avoid written correspondence containing anything other than statement of materials forwarded to agent

- a. Letters in which you make allegations, take legal positions, or otherwise include substantive material often cause administrative difficulty within the Service
  2. Most agents prefer phone contact
  3. Attempt to pare down information and document request in initial phone conferences
    - a. Try to eliminate materials that Service should already have; materials that you do not have and which will be expensive or time consuming to recover; and any materials which you believe beyond material scope of the audit
- D. Conference with agent
  1. Agents now operate out of home and PO Box - use Fed. office only for conferences
  2. Try to hold in counsel's office if possible
    - a. Best access to file
  3. Never have client present
    - a. Agent may ask client questions
    - b. Client may answer questions
    - c. You may look bad trying to get client not to answer questions
    - d. Client may not appreciate your attempts to develop a rapport with the agent
- E. Negotiating terms with agent
  1. Agents are only concerned with their group performance, so attempting to trade off income tax or related issues is probably not beneficial
  2. Attempt to settle items before agent hires appraisers or makes other expert hires
    - a. Need to justify costs on a particular examination can polarize negotiations when agent needs some recovery
  3. Threat of "attorney fees" (unsupported positions) is both not relevant to agent and further, not material to Service as it comes out of general revenue as opposed to IRS budget

4. Be familiar with estate tax examiners handbook so you can focus on the issues the agent must, as a matter of administrative procedure, follow
5. Negotiate to an agreed assessment, and if not satisfactory, a refund
  - a. Agent not likely to rewrite a case, particularly if time is limited, and you are likely to get a more favorable write-up with less extreme IRS positions if consent to an assessment
6. Have documentation of basis for any “estimated” items which cannot be fully documented prior to closing, such as additional administration expenses
7. Never condescend to an agent
8. Disclosure is one thing, argument is another. Create the impression that you have “emptied your files” and turned over everything except privileged materials
9. No “duty” to “supplement” return (and no “Amended” 706 Form); but must fully and accurately respond to all information requests
10. Best treatment of unagreed item, on which agent cannot or will not budge, is write-up to next level
11. Some issues (FLP) have audit treatment dictated by national office; agent truly has no discretion
12. Agents are not allowed to consider litigation issues, costs, or collectability issues in assessing tax

V. Executor Duties and Liability Exposure

A. Scope of Personal Liability

1. Duty to pay -- §2002
  - a. Executor is liable for tax to extent of property in his possession
    - (1) In addition, personally liable to extent Executor makes distributions or pays debts before all estate tax is paid
    - (2) However, Executor may pay administration expenses (that are not debts) without incurring personal liability to the extent of the unpaid estate tax
  - b. Only if amounts paid to a creditor whose claim is subordinate to U.S. claim, limited to probate assets

- c. Others “personally” liable -- §6324(a)(2); ten-year lien on property, liability limited to extent of “value” of property at date of death
  - d. Trea. Reg. 20.2002-1 -- if no executor, any person in actual or constructive possession of decedent’s property is required to pay entire tax to the extent of the value of the property in his possession. (No date for value indicated in regulations)
  - e. Personal liability is limited to distributions made to beneficiaries, creditors and others in preference to the IRS claim
2. Discharge of Executor from personal liability for Decedent’s Income and Gift Taxes -- §6905
- a. Claims period does not apply
  - b. Personal liability can be limited to nine months if §6905 request made
3. Nine-month letter -- §2204
- a. Good practice to include “prompt audit” letter with every return which requests IRS to discharge Executor or administrator from personal liability within nine months of filing return
    - (1) file with every return (must be mailed separately and file copy with return)
  - b. May ask you to withdraw letter - refusal to withdraw may precipitate deficiency assessment
  - c. Effect: w/i 9 mos., IRS is to notify Executor of amount of tax due, after which personal representative discharged of an additional payment/obligation due
    - (1) if no IRS notice received it is believed PR is discharged (but IRS disputes this as to distributions and payments)
    - (2) Seems to include non Exfiduciary if no Executor appointed
- B. Important to caution Executors as to gravity of obligation - usually discussion of Additions to Tax and Penalties will do that
- 1. Failure to file tax return or pay tax -- §6651
    - a. File -- 5% each month up to 25%

- b. Pay -- 0.5% per month up to 25% unless IRS gives notice under §6651(d) - then 1% per month
- 2. Additions due to negligence or fraud -- §6653 - §6663
  - a. Fraud - penalty is 75% of underpayment
  - b. Negligence - 5% underpayment
- 3. Interest
  - a. Payable from due date to date paid
  - b. §6621 - authorizes quarterly adjustment (sum of short term federal rate plus 3%)
  - c. Underpayment - applicable percent compounded daily (§6622)

## VI. Closing Audit and Review Process

### A. Settlement of Audit

- 1. Form 890 - either agent or appeals officer may issue
  - a. Makes deficiency immediately assessable (§6213(d))
  - b. Stops running of interest on deficiency within thirty days of effective date
  - c. If ninety day letter not already issued, fiduciary loses right to petition Tax Court
- 2. Closing letter -- Rev. Proc. 85-13, 1985-1 CB 514
  - a. IRS will not reopen case closed within the three-year statute after examination to make unfavorable adjustment to taxpayer unless:
    - (1) Evidence of fraud, malfeasance, collusion, concealment, misrepresentation of material facts; or
    - (2) Prior closing involved clearly defined substantial error based on an established service position existing at time of previous examination; or
    - (3) Other circumstances exist that indicate failure to reopen would be serious administrative omission
    - (4) See also IRS "bounty" 10% audits

- b. Remember - closing letter not binding on District Director or Taxpayer
  - (1) Estate can still claim refund
  - (2) District Director can still assess deficiency
  - (3) UNLESS - if tax payer and District Director enter closing agreement, then DD barred from opening estate up unless fraud shown

B. Unagreed Cases

- 1. Two intra-IRS methods of removing issue from agent who has taken unacceptable position
  - a. Request Technical Advice (“TAM”)
    - (1) IRS National Office provides statement on proper application of tax law, treaties, regulation or revenue ruling to specific set of facts involving specific taxpayer -- will be done in four situations:
      - (A) Examination of return;
      - (B) Consideration of taxpayer claim for a refund or audit;
      - (C) Miscellaneous matters under jurisdiction of the Chief, Examination Division of District Director’s Office; or
      - (D) Consideration of nondocketed case by Appeals Office
    - (2) Grounds:
      - (A) Lack of uniformity in Service’s disposition of issue; or
      - (B) Issue is unusual/complex enough to warrant;
    - (3) Either taxpayer or agent can request
      - (A) Include: Power of Attorney, Form 2848, Request for Technical Advice; Statement of Facts; Examiner’s comments; Taxpayer’s brief; and copies of all pertinent documents

- (4) Process:
    - (A) Once request received by National Office, representative will contact District or Appeals Office within twenty-one days to discuss
    - (B) If advice is adverse to taxpayer, taxpayer has right to one informal conference with National Office branch considering matter within twenty-one days of ruling; Taxpayer has twenty-one days after conference to submit additional information
    - (C) If advice is favorable to taxpayer, District Director and Appeals Office must follow it
  - (5) Pros and Risks
    - (A) Delays in audit process
    - (B) Eliminates agent's discretion
    - (C) Might avoid litigation if agent taken uncompromising position which taxpayer has reasonable prospect of receiving National Office endorsement
    - (D) Might stop unreasonable agent from misapplying stated National Office position (discernable through research of PLR, TAM, etc.)
  - (6) Practical matter:
    - (A) Rarely used
    - (B) If you must resort to this, you are probably very far apart from agent; save money and tell agent to write it up (expensive as PLR)
- b. More likely process - Appeal Process
- (1) Receipt of thirty (30) day letter
    - (A) Usually issued only if assessment deadline (3 years from filing 706) is more than 6 mos. away
    - (B) 30 day letter is not mandated by statute or regulation but is IRS attempt to expedite process

- (C) Contains agent's proposed adjustment in an examination report and gives taxpayer 30 thirty days to respond to agent's report
  - (D) If proposed deficiency less than \$25,000, TP may request informal hearing w/o written request
  - (E) If proposed deficiency more than \$25,000, TP must file written protest
    - (i) can either write letter covering it all or write supplemental brief
- (2) Written protest must be filed with Service; no required format but should contain (see IRS Pub. 556 and Publication 5) (addressed and sent in duplicate to District Director):
- (A) Taxpayer's name, address, identification number and telephone number;
  - (B) Date and symbols from 30-day letter;
  - (C) Tax period and year involved;
  - (D) Statement of adjustments not agreed to;
  - (E) Statement of facts and law in support of position;
  - (F) Request for conference with Appeals Office; and
  - (G) Declaration, under penalty of perjury, that facts stated are true
- (3) Appeals officer generally refrain from raising new issues but may do so if tax amount is material (may justify taxpayer going straight to Tax Court)
- (4) Meeting with Appeals Officer and taxpayer
- (A) Attorney should be well versed in law; do not hesitate to make offers or be surprised that agent makes counteroffer
  - (B) Appeals officer usually well versed in law - selected primarily for their technical competence, objectivity and impartial demeanor

2. Ninety-day letter -- Notice of Deficiency and Form 890 accompany
  - a. Must be issued within three-year statute -- if less than six months remain in statute period, often is issued instead of 30-day letter
  - b. Taxpayer may either:
    - (1) Agree to deficiency and pay -- then file refund claim with IRS and litigate in either U.S. Court of Claims or District Court; or
    - (2) Disagree to deficiency and file complaint in Tax Court
  - c. Considerations if taxpayer pays deficiency and wishes to file for refund:
    - (1) Ascertain Limitation Period
      - (A) If taxpayer wishes to claim a refund in excess of amount of deficiency assessed and paid, must file refund claim within the three-year statute of limitations period for filing and paying tax
      - (B) Otherwise, taxpayers have two years from date of payment of deficiency to bring refund case
      - (C) Exc.: §2011(c) -- if refund due to increase in state and foreign death taxes -- 4 years from date of filing
      - (D) Rule of Thumb: three years and 9 months after DOD, unless return extended
    - (2) Use Form 843 -- follow form and reg. 301.6402-2(b) to complete Form and supplemental statement re grounds exactly and full amount claimed, plus interest
    - (3) Weigh chances of increased stringent audit and less chance of acceptance without audit against validity of claim and amount of tax to be recovered
    - (4) After filing refund claim with IRS, must wait six months before filing case in District Court or Court of Claims
    - (5) May request "Prompt Disallowance of Refund"
    - (6) Strategies on timing of filing 843, as it can trigger new audit if within statute

3. Litigation -- Choice of Forum

a. U.S. Tax Court

- (1) Must go to Tax Court if taxpayer does not pay tax
- (2) Advantages
  - (A) Pretrial proceedings may be less expensive because discovery less extensive; facts often “stipulated”
  - (B) Judges, not magistrates, handle pretrial conferences and discovery
  - (C) Expertise in tax issues
- (3) Disadvantages
  - (A) Statute of limitations suspended so IRS can claim increased deficiency based on new issues -- §§6214(a), 6503(a)
  - (B) Identity of judge not known until several months before case is set for trial (judges ride the circuit)
  - (C) Statistically, appears to be pro-government
- (4) IRS represented by Chief Counsel’s Office
  - (A) If Appeals office had not previously considered case, case will be referred to Appeals if District Counsel believes there is a likelihood of settlement. Rev. Proc. 82-42, 1982-2 CB 761.

b. Court of Claims or District Court

- (1) Prerequisites
  - (A) Must pay tax
  - (B) Must file case within statute of limitations - §6511(a)
  - (C) Claim must carefully and completely set forth grounds relied on for refund

- (2) Procedural
    - (A) Government usually represented by Tax Division of Department of Justice
    - (B) Settlement authority more prescribed than Tax Court
  - (3) Claims Court
    - (A) Headquartered in D.C.; judges ride circuit
    - (B) No jury available
    - (C) Statistically seems more sympathetic to taxpayer than District
  - (4) District Court
    - (A) Based locally
    - (B) Jury trial
4. Statute of Limitations
- a. Three-year after filing return; §6501(a)
  - b. Six-year
    - (1) Omission of item in excess of 25% of gross estate stated in the return; §6501(e)
      - (A) 25% omission -- six-year note -- §6501(e)(2) (for both estate and gift tax returns)
      - (B) Omission test does not include items disclosed on return schedule statement attached thereto) in a manner sufficient to apprise district of nature and amount of item
    - (2) Collection of tax -- within ten years after assessment is made (or such other time as Commissioner and executor decide); §6502(a)
  - c. Ten-year lien from date of death to collect unpaid tax from executor, other fiduciaries and other transferees; §§6324(a)(1), 6901; Treas. Regs. 20.2002-1, 301.6324-1(a), 301.6901-1, 301.6903-1

- d. Transferee liability -- anyone in possession of property included in taxable estate to the extent of the value of the transferred property - 6324(a) (2)
  - (1) Adds one year to limitation period to each transfer (no more than three years after expiration of basic limitation period)

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