IRS Audit and Litigation Trends for Estate and Gift Tax

Presented By

Josh O. Ungerman, J.D., CPA

MEADOWS COLLIER
ATTORNEYS AT LAW
MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN, L.L.P.

901 Main Street, Suite 3700
Dallas, Texas 75202
(214) 744-3700 / (800) 451-0093
Fax (214) 747-3732
jungerman@meadowscollier.com

LEGISLATION THOUGHTS

- Will the 2026 exemption reversion be changed?
- Green book proposals are similar to those in prior years, but show that someone is paying attention to what planning is working for wealth transfers.
- Congress desire to limit or eliminate certain wealth transfer techniques.
- Taxpayers have been successful in attacking regulations with APA challenges, etc.

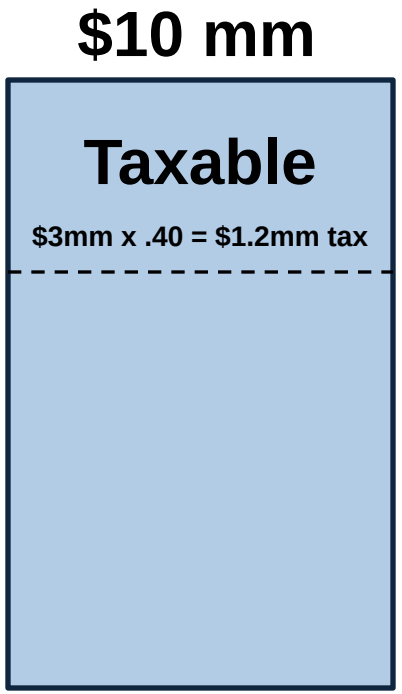
CORPORATE TRANSPARENCY ACT

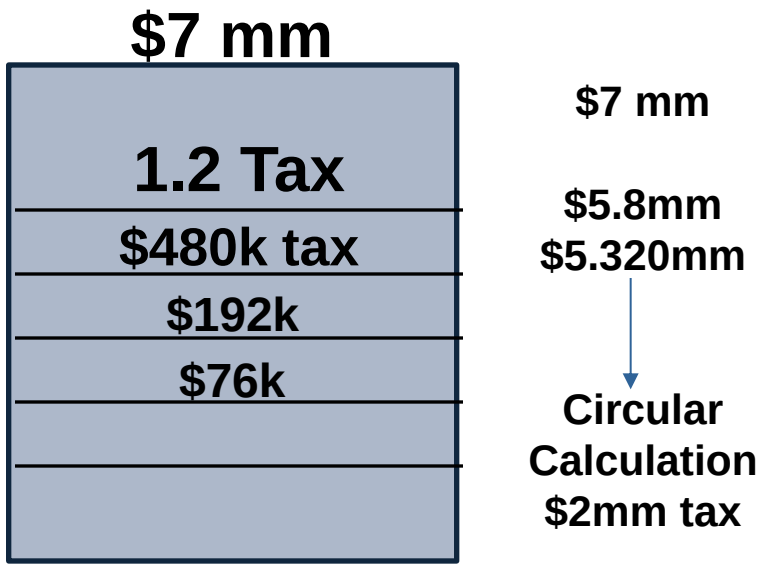
- The Corporate Transparency Act ("CTA") will require small, privately-owned companies to report their ultimate individual owners to the federal government.
- Many estate plans include companies and entities that will be subject to CTA.
- In general, CTA requires that the "reporting company" file with FinCEN (Financial Crimes Enforcement Network of the Department of Treasury) a report that identifies each "beneficial owner" of the reporting company and the "applicant" of the reporting company. The following information is required for these persons: full legal name, date of birth, current address and unique identifying number (i.e., passport, drivers license).
- In addition, the reporting company is required to file updated reports with FinCEN within 1 year after there is a change in the information previously provided to FinCEN by the reporting company. Again, regulations will be needed to further clarify this requirement.
- CTA includes penalties for willfully providing false or fraudulent information or willfully failing to report or update information or knowingly disclosing information. The penalties are both civil and criminal.

FRONT LINES OF IRS ENFORCEMENT

- Valuation Discounts – Generally accepted and often challenged.
- Tax Affecting – Generally approved. Cecil TCM 2023-24.
- Defined Value Clauses, i.e., Wandry Clauses (e.g. Transfer or sale $3mm of stock. Need appraisal. IRS position excess over defined value is a gift. Gravitating more taxpayer favorable. Expect an IRS challenge.).
- “Reciprocal” SLATs pulled back into the estate.
- Use of post date events by the IRS as a sword or a shield.
- Gifts to charity.
- IRC Section 2036 challenges and mismatch scenario.

FRONT LINES OF IRS ENFORCEMENT





Gross Estate Is increased Under 2036

Marital Deduction/Trust is reduced from $7mm to $5.8mm So pay tax $1.2m x 4 = $480K Circular Calculation

Before = 0 tax
End = Almost Double Tax

FRONT LINES OF IRS ENFORCEMENT

- Recharacterization of transaction as a gift/unreported gift – result is no gift tax return. Consider filing “protective” no gift tax return with description of the facts and circumstances.
- Statute of Limitations – No 709 extension. Statute of Limitations – The IRS position is if a gift tax return did not disclose the transaction; it can be examined. Gift tax adjustment with penalties and interest (watch out for corresponding 706 adjustment) and increase gross estate for gift previously made and decrease for amount of gift tax paid or due plus interest.

STRETCHED RESOURCES

- 2023 Filing and 2021 Audit Statistics for 706's and 709's
- Estate Tax Returns (Form 706)
- 2023 Total returns filed—49,633
- 2021 Total returns filed—32,374
- 2021 Closed Examinations—23
- 2021 Open Examinations—135
- 2021 Audit Coverage—0.59
- 2021 No Change Examinations—10
- 2021 Remediation for Additional Tax — 3,858

STRETCHED RESOURCES

- Gift Tax Returns (Forms 709)
- 2023 Total Returns filed—516,991
- 2021 Total Returns filed—448,155
- 2021 Closed Examinations—18
- 2021 Open Examinations—40
- Received Additional Tax—34

AGENTS

- There are not enough Estate and Gift Tax examiners on a nationwide basis.
  - They are very understaffed;
  - Some areas of the country have no local agents, particularly problematic, because Estate Tax questions often turn on state law issues;
  - Estate and Gift Tax Agents typically have few resources; e.g. audit aids. Funding shortfalls also impede hiring experts, especially outside valuation experts.
- Two decades of tinkering with the Estate Tax, proposing its abolition (and doing so once) has taken a toll.

LONG DISTANCE AUDITS

- The scarcity of agents leads directly to long distance audits where out-of-state examiners try to work cases. This is typically a recipe for disaster.
- The agent does not know local law and cannot rely on IRS Counsel for guidance. For example, agents unfamiliar with mineral law or community property examining Texas estates.
- Lack of funds prevents agents from actually meeting with representatives; so no chance for face–to–face communications.

AGENT ATTRITION

Many Estate and Gift Tax Agents are eligible for retirement, and simply do so. This leads to a less experienced talent pool and disrupts ongoing audits. Opportunities in the private sector lure younger agents (who are after all, attorneys). So the IRS is hemorrhaging talent at both ends of the age spectrum.

ADJUSTMENT CLAUSES

- Adjustment clauses are found in the transfer documents moving assets into FLPs (etc.) or transferring fractional equity interests to younger generation partners. In various forms they provide that, if the IRS determines the value to be different than originally claimed the transfer is adjusted; either by contracting the transfer, treating the excess as an additional gift or adjusting the sales price. If these clauses are effective they generally would eliminate any current tax deficiency. See *King v. U.S.*, 545 F.2d 700 (10th Cir. 1976).
- Traditionally, the IRS has argued that such clauses are against public policy because they negate the IRS's incentive to determine additional taxes. In my opinion, a suspect argument since the IRS's goal should be the correct tax, not just more tax. The IRS's rationale was initially accepted by the court, but is increasingly disfavored.
- The IRS appears to be hesitating to take adjustment clauses to court.

POINTS TO CONSIDER ABOUT ADJUSTMENT CLAUSES

- As litigation fills in details about adjustment clauses, expect courts to consider:
  - The reality of the clauses; were they just boilerplate or did the parties intend for them to be effective?
  - Proof that the parties actually negotiated the clause; perhaps with separate council.
  - This is especially important where the younger generation partner could be taking on additional burdens under the clause; e.g. paying additional amounts in a gift/sale scenario.

NEW IRS TACTIC IN OIL AND GAS CASES

- The IRS has never truly accepted the theoretical moment-of-death or moment-of-gift time formulation of the classic valuation definition. So they have continued to try to muddy the water in court; especially where an asset is in transition at that date.
- Example: Decedent passed away while an existing oil well is being reworked using parallel drilling. So, on the date of death one well exists, but within weeks, multiple wells have a high probability of coming in. Traditional reporting would be for the original well, disregarding the incomplete prospective wells. Now where the wells have been initiated, but not completed, the IRS is arguing for their inclusion in the Estate's 706. Their theories are not fixed. They sometimes argue the new production is "foreseeable" and should be valued. Other times, they argue that the incomplete well has value as of the date of death and simply peg it's value on post-death production data.
- I do not think this will ultimately be successful, but will require litigation. The Fifth Circuit is very precise (and pro-Taxpayer) on the date issue.

TAX EFFECTING

- Tax Effecting is a valuation question effecting S Corporations. The argument is that S Corp earnings are subject to individual tax rates whether or not they distribute and that the additional cost should be factored into valuation. This can be a very significant additional discount. The IRS naturally opposes Tax Effecting.
- The Tax Court has ruled that Tax Effecting may be appropriate in some cases, but has not found such a case. This opens the theoretical door to Tax Effecting, but provides no guidance.
- The valuation literature, in general, now supports Tax Effecting.
- The IRS counters this by instructing its valuation experts not to consider Tax Effecting. Question: Does this invalidate the opinion? If the expert supports Tax Effecting and is instructed not to do it, is it still his opinion?
- There is a SPLIT of opinion among the single group of IRS Appeals officers as to its appropriateness; so whether you get Tax Effecting may be the luck of the draw.
- See the pending Tax Court case of *Cecil v. Commissioner,* Docket Number 14639-14; which directly addresses the issue and whose opinion may give us an answer.

INCREASE USE OF SUMMONS POWER

- Section 7602 allows the IRS to issue a summons in aid of an examination. Traditionally, summons are reserved for non-cooperative taxpayers or cases where the IRS is up against the Statute of Limitations; so they were fairly rare.
- Section 7609 provides for a special category of summons directed to a “third-party record keeper” that creates a series of specialized rules for attempts to force production. These were, until recently, exceedingly rare.

SUMMONS VS. SUBPOENA

- The terms are often confused.
- Summons:
  - An administrative request for documentation or testimony issued by an agency. Virtually all agencies have some variation on the summons: EPA, SEC, and IRS. It is not "self-enforcing;" meaning that, within parameters, noncompliance does not subject the recipient to sanctions. Summons are always used in civil matters.
- Subpoena:
  - Issued by a court and noncompliance can result in contempt-of-court proceedings which can include serious consequences. Subpoenas issued by the IRS are either criminal or civil in a trial type setting.

WHAT DID I MEAN ABOUT SUMMONS NOT BEING "SELF-ENFORCING"?

- Noncompliance with a Summons appears to be a serious matter. Section 7210 prescribes one (1) year in prison and a $1,000 fine for an individual who "neglects to appear or to produce." To my knowledge, there has been a single prosecution under this statute about 60 years ago. More importantly, there have been a series of Supreme Court decisions making it clear that a summoned individual has the obligation to physically appear at the appointed time and place, but is immunized from prosecution if they interpose "good faith objections."
- The IRS prominently prints 7210 on the Summons' form, but neglects to mention the case law.

OBJECTIONS TO SUMMONS

Traditionally, the summons power has been broadly interpreted. But the 2014 U.S. Supreme Court case of *U.S. v. Clark* gave the Taxpayer a much stronger hand by requiring the IRS to issue the summons in good faith.

WHY YOU SHOULD EVALUATE A SUMMONS

- With the IRS's use of summons on the upswing, thoughtful consideration of your response is in order.
- The IRS has probably issued a summons to "shake you up" and perhaps to intimidate the Taxpayer. In my opinion, examination by intimidation is a dubious rationale.
- It is not always in the best interests of the client to comply where the IRS has chosen to squander its Congressionally determined statute of limitations.
- Evidentiary privileges are perfectly legitimate objections to summons and need to be asserted or they may be waived. I have seen the IRS issue summons simply to trick the Taxpayer into waiver.
- Commonly, the IRS overreaches in its summons, directing the Taxpayer to produce documents or explanations. Summons can only seek pre-existing documents or testimony. They cannot require the Taxpayer to create anything.

WHAT HAPPENS IF THE IRS WANTS TO ENFORCE A REGULAR SUMMONS?

If the IRS is unhappy with a response, or the Taxpayer interposes good faith objections, then the IRS must persuade the Dept. of Justice to file suit to enforce the summons in Federal Court. This is far from certain since the DOJ resources are stretched thin. A significant number of summons simply fade away.

IS IT DIFFERENT WITH A THIRD-PARTY RECORD KEEPER SUMMONS?

Yes, the procedure is completely different. The Taxpayer must initiate the suit to block production with strict time limits. (Discussion of these summons are beyond this presentation, but if you are subject to this type of summons, hire counsel to make sure you stay safe!)

EFFECT ON THE STATUTE OF LIMITATIONS

- Issuance and/or enforcement of a regular summons has no effect on the statute of limitations.
- A summons issued before the issuance of a stat notice may be returned after that date; or even after the filing of a Petition with the U.S. Tax Court. This seems to be a bad faith situation on its face since the stat notice is a "final determination of liability" and the conclusion of the administrative process so there is no longer an examination.
- A summons issued after a Tax Court filing is suspect. See *Ash v. Commissioner*, 96 TC 459 (1991).
- However, there is a special rule for Third-Party Record Keeper Summons – See 7609(e).

TRANSFER TAXES AND APPEALS

- There are now a limited number (estimated at seven (7)) Appellate Officers that are qualified to consider transfer cases; nationwide. They appear to be geographically spread, but under unified management. The nearest to us is located in Houston. This makes virtually all Estate and Gift tax appeals long distance affairs.
  - Budgetary limitations make in-person meetings rare.
  - Most appeals now take place in a docketed format because the entire statutory period is consumed in the examination.
  - This leads to complications because the Tax Court docket now moves more quickly than the bottleneck of Estate and Gift tax appeals.
  - No appeals process is applicable to refund actions in District Court or Court of Claims.

NEW APPEALS LIMITATION ON "NEW EVIDENCE" CREATES A SIGNIFICANT PROBLEM

- Appeals traditionally does a good job of resolving litigation bound cases by providing an objective, and independent arbitrator. The percentage of all Tax Court disputes resolved this way historically hovers around 90%.
- A new Appeals policy threatens this by limiting their ability of evaluating new evidence. In theory, the "facts" and much of the argument are supposed to be fixed when a case moves from exam to appeals. If the Taxpayer presents what the officer deems "new evidence," then it is supposed to be referred back to exam and evaluated on a 45 day turnaround. There are many problems with this:

PROBLEMS

- What the appeals officer perceives as new evidence is subjective.
- There is no procedural rule limiting a Taxpayer's right to introduce new evidence or arguments at this stage, so all you are doing is restricting the officer's ability to look at the same evidence the Court would. This is particularly suspect since in theory that is precisely what the officer is supposed to do.
- Practically any surprise or shift in argument is treated as new evidence so this procedure is invoked automatically. Since cases are typically shifting to counsel at this point it is not unusual for analysis to change.
- The shift back to exam is problematical:
  - exam may be too busy to take it back;
  - the 45 day response time gets extended; and
  - this further congests the appeals/Tax Court timeline.

CHOICE OF FORUM AND EXPERTS

Since tax cases can be tried in either Tax Court or through Refund Litigation, you have to pay special attention to which forum you might end up in. Traditionally, the vast majority of tax cases are resolved through the Tax Court, but increasingly refund litigation primarily in District Court is becoming popular.

TAX COURT

The Tax Court has arcane rules for expert testimony.

- Since there is no jury, the Court applies the rules of evidence loosely and concentrates on trying cases quickly.
- While expert reports will have appeared at audit and during pretrial negotiations, the identity of the testifying expert need only be revealed 30 days prior to trial.
- While the rules contemplate expert depositions, they are rare. Depositions of an expert revealed at the last minute are impossible.
- The expert's report is considered to be their direct testimony. The offering party qualifies the expert, "lodges" the report, sits down and the other side begins cross examination. The offering side will be able to redirect but has limitations on subject matter.
- At the conclusion of the trial, it is rare for the Court to issue a bench decision. So normally, months are consumed in briefing and memories fade.

CONCLUSIONS ON TAX COURT EXPERTS

- You want to select a GOOD WRITER who generates a very thorough report.
  - This will mean a long report because it must cover every conceivable subject, you have little or no chance to cover an omission through testimony.
  - Oral skills are secondary to literary ones because by the time the judge reads the report, months will have passed.
  - The Judge's clerk who may be primarily responsible for drafting the opinion probably will never hear the expert.
- Factual or analytic mistakes are very likely because experts are not subject to deposition; making your review of your expert's work crucial.
- The ability to change experts because of the 30-day Rule is an invaluable advantage to the Petitioner.

WHAT ABOUT REFUND CASES?

Refund Basics:

- Starts with the filing of a refund claim (Form 1040X or 843).
  - This is even more critical than a Stat Notice, because it must be very complete.
  - It must contain every grounds for refund that will ultimately be used in Court; any shift in argument runs the risk of being a “variance.”
  - A variance will not be considered by the Court.
- A refund claim can either be spontaneous (in that the Taxpayer now believes a prior filing position to be erroneous) or purposeful (the IRS audited a return, proposed a deficiency, the Taxpayer paid the tax and is now disputing it).
- The tax has to be paid.

WHAT ABOUT REFUND CASES?

Refund Claims:

- A refund has to be filed within strict time limits; the later of 3 years from the date of filing of the return giving rise to the refund, or 2 years from payment.
- Once filed, a refund claim may be audited, or the government may choose not to act on it.
- If they initiate an audit, the Taxpayer must let that process complete; the so-called "administrative remedy" must be allowed to play out. If the audit results in a disallowance of the refund then a Notice of Disallowance will be issued and the Taxpayer has 2 years to initiate a refund suit.
- If the Government does not initiate an audit within 6 months, then the Taxpayer has jurisdiction to bring a refund suit. It is irrelevant if an audit occurs at that point.

SETTLEMENT IN TAX COURT V. DISTRICT COURT

The overwhelming majority of Tax Court cases settle on some basis; the entire system is set up to encourage compromise and actual trials are functionally disfavored.

- While settlement is still encouraged in District Court, it is practically more difficult.
  - ➢ No Appeal Division in District Court litigation.
  - ➢ Very difficult to mediate with the government because they can not produce a person with settlement authority.
  - ➢ Refunds over $2 million require Congressional approval.

DISTRICT COURT

Costs in District Court:

- District Court cases do not have the docket constraints of Tax Court cases. So, assume the government will take full advantage of pretrial discovery. Pretrial discovery is usually the most expensive component of litigation.
- Trials in District Court are typically much longer and much more formal than Tax Court.
- It is possible to have a jury in District Court (not so in Tax Court) which complicates the trial exponentially.
- Post trial briefs may be avoided, which cuts costs, but in a bench trial may still be necessary.
- Unlike Tax Court cases, where costs start slow and build to a crescendo, District Court cases start out expensive and stay that way.

REFUND LITIGATION IN U.S. DISTRICT COURT

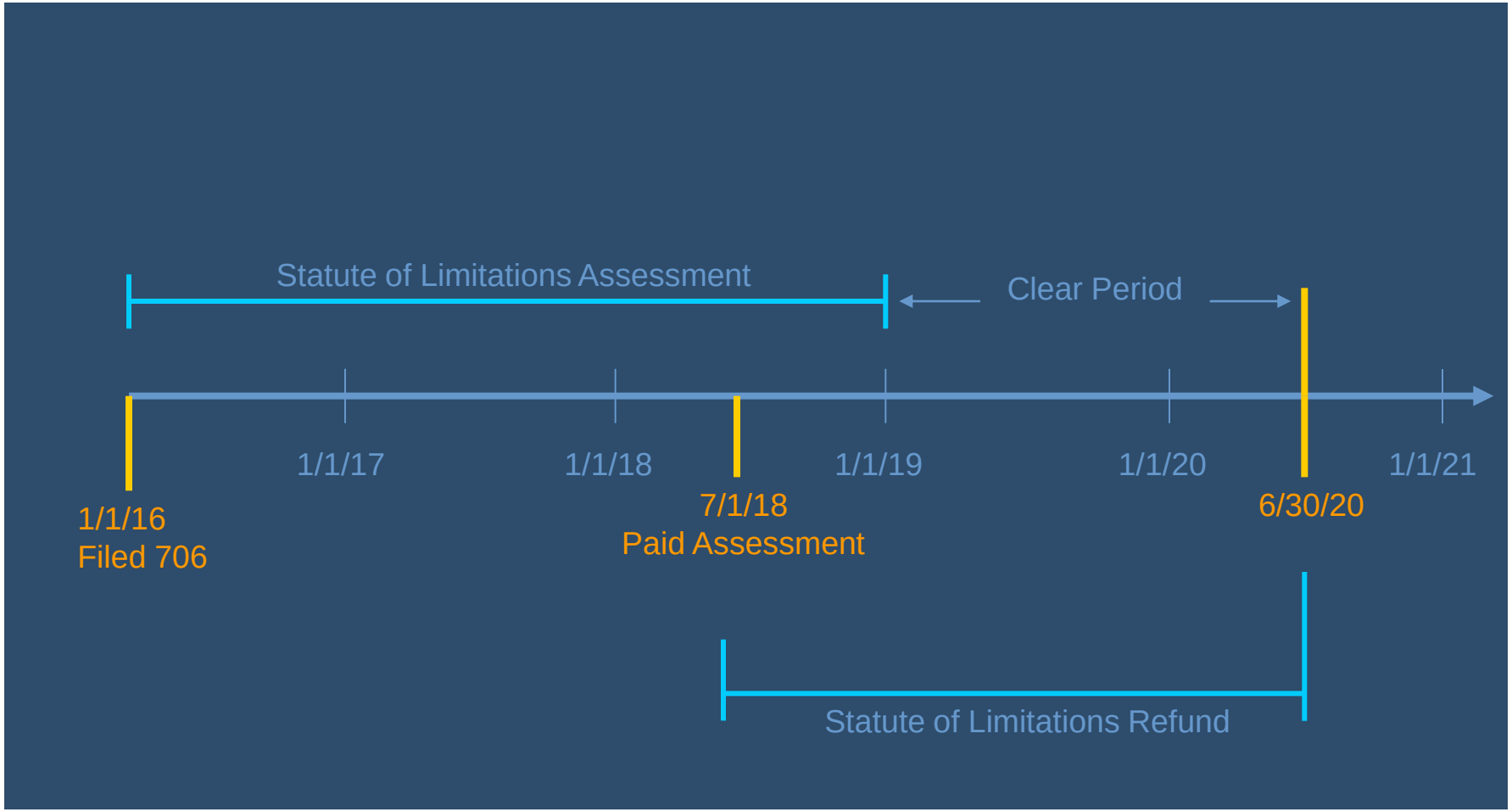
District Court rules are more reasonable.

- Since the possibility of a jury trial exists, the Court is very careful about evidentiary rules.
- The Scheduling Order will require identification of experts and exchange of reports much earlier.
- Expert depositions will occur.
- If tried from the bench, an immediate decision is still unlikely, but verbal skills are more important. There will probably be less time lag between testimony and decision, and the clerk will almost certainly be in the courtroom.
- The expert gets to testify on direct.
- It is very difficult to change experts and if you do last minute depositions will occur. The most that is possible is to list multiple experts as witnesses and then choose which one you call.

WHEN A DEAL ISN'T FINAL

Example: Let's assume that the Estate timely files the 706 on January 1, 2016. Further that, an examination occurs resulting in a settlement, with an agreed deficiency in Estate Taxes on May 1, 2015; well within the normal 3 year statute of limitations on assessment. A Form 890 is executed, a billing generated and payment of the additional tax occurs July 1, 2018. The Estate takes the settlement to limit its downside risk for additional taxes, but wanted to maintain the option of arguing for a reduction in tax. The statute of limitations on assessment will run on December 31, 2018; the refund statute of limitations will run on June 30, 2020. As such there is a clear 18 month period in which a Refund Claim (Form 843) is timely, but during which it is impossible for the IRS to assert an additional deficiency (1/1/2019 through 6/30/2020). A Refund Claim filed during that period could give rise to a refund action in the U. S. District Court (with proper venue) 6 months after filing. In such a suit the government would be allowed to reopen the original return to create a counterclaim for additional offsetting taxes, but would not be allowed to bring suit for a net deficiency--in other words the Estate can pursue its refund with no fear of a net amount due.

WHEN A DEAL ISN'T FINAL



CONCLUSIONS OF REFUND LITIGATION EXPERTS

- While you still like a good writer, a much shorter report is called for.
  - A long report gives the other side more fodder for the deposition, and
  - The expert will have the luxury of direct testimony.
- Greater emphasis on verbal skills and demeanor, especially in a jury trial.
- The expert must be able to defend himself on deposition.

JOSH O. UNGERMAN

Partner

phone (214) 744-3700
toll-free (800) 451-0093
fax (214) 747-3732
jungerman@meadowscollier.com

Mr. Ungerman specializes in tax controversies in addition to tax, business, estate and charitable planning. He has been involved with both domestic and international tax disputes in the United States Tax Court, the United States District Courts, and the United States Circuit Courts. The tax matters in which Mr. Ungerman is involved are typically very complex from both a factual and legal perspective. These matters often require legal and accounting skills. Mr. Ungerman is also a Certified Public Accountant.

Mr. Ungerman has been quoted on tax and estate matters in Forbes, Bloomberg, The BNA Daily Tax Report, and Tax Analysts-Tax Notes. The Chambers USA Guide describes Mr. Ungerman as “Incredibly dedicated: He lives and breathes his client’s problems,” and further reports, “If I knew somebody in a difficult position with the IRS, I’d definitely call Josh.” Chambers USA describes the firm as a boutique which “draws resounding praise for its ‘fantastically capable litigators,’ who have extensive tax and white-collar crime litigation experience and expertise,” and “frequently advises on criminal, income, and estate and gift tax matters.”

Mr. Ungerman is a frequent speaker on tax topics including exams, IRS estate tax strategies, tax shelter defense, recent tax legislation, IRS criminal tax investigation techniques, and state tax controversy issues. Mr. Ungerman is quoted in BNA's Daily Tax Report on August 15, 2011, in an article titled, "Taxpayers Fear Disclosing Offshore Assets As Deadline Approaches, Practitioners Say." He is also quoted in an article, “Applying Mayo Federal Circuit Defers to Controversial Overstated Basis Regulation” by Jeremiah Coder in Tax Notes by Tax Analysts, March 14, 2011, and also in the article, "Seventh Circuit Overturns Tax Court on Gross Income Omission" by Jeremiah Coder in Tax Notes by Tax Analysts, January 31, 2011. Alan K. Davis and Josh O. Ungerman published an article, "An Untaxing Year" in the December 20, 2010, Texas Lawyer, Vol. 26., No. 38. Josh O. Ungerman is also quoted in an article, "IRS Withdraws 'John Doe' Summons Against UBS Over Tax Fraud Allegations" by Daniel Pruzin (Geneva) and Alison Bennett (Washington) in the Daily Tax Report, November 17, 2010. Mr. Ungerman was quoted in three Tax Practice articles (published weekly by TaxAnalysts) on May 24, 2010, “IRS Undeterred After Tax Court’s Intermountain Decision”, April 12, 2010, "IRS Help for Struggling Taxpayers Contrasts With Enforcement Push" and on April 5, 2010, "Federal Circuit Overturns Penalty Determination in Jade Trading". Mr. Ungerman is also quoted in an article published on taxanalyst.com entitled, "Swiss Agree to Expedite Processing of 4,450 UBS Accounts Under Treaty Request" by David D. Stewart on August 20, 2009. He was also quoted in an article on bloomberg.com entitled, "Billionaire Tax Felon Says UBS Lied in Pledge to Report to IRS" by David Voreacos on June 9, 2009. Another article he was quoted in was published on moneylaundering.com entitled, “Uptick in Tax Evasion Disclosures Mean More Bank Investigations, Say Attorneys" by Matt Squire on November 5, 2008.

Mr. Ungerman is quoted in the book, “The Cheating of America: How Tax Avoidance and Evasion by the Super Rich Are Costing the Country Billions–and What You Can Do About It" by Charles Lewis and Bill Allison and the Center for Public Integrity.

Mr. Ungerman was admitted to practice in Texas in 1990.

DISCLAIMER

The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.

558522