

San Antonio Estate Planning Council  
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# IRS Estate and Gift Tax Examinations in the Age of Higher Exemptions

Presented By:  
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## Where Are We?

- The estate tax exclusion amount for 2020 is \$11,580,000 or \$23,160,000 for married couples.
- The annual exclusion for gifts for 2020 is \$15,000.
- The estate tax exclusion will revert to \$5,000,000 on January 1, 2026.
- The IRS has estimated that there will be 4000 Forms 706 filed in 2020 with less than 10% taxable.

## Stress Testing the Estate Planning

- The most litigated transfer tax issue IRC Section 2036 where the IRS argues that although assets are transferred, there is an implied agreement of retained enjoyment or control and the assets should be included in the estate.

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## Stress Testing the Estate Planning

- Now is the time to stress test the planning and blunt the arrows in the IRS' quiver:
  - Have gift tax returns been filed and do they adequately disclose the gifts?
  - Have all the income tax returns been filed?
  - Do the tax returns, transfer documents and appraisals match?
  - Are the entities in good standing?
  - Are the clients respecting the legitimacy of the entities and following formalities?
  - Is the client relying on distributions from the entity or is it making disproportionate distributions?
  - Is the client commingling personal assets with entity assets (“living out of the partnership”) or using partnership assets (vacations at the Aspen condo and Maui pad)?
  - Are there transfer documents evidencing contributions to the entity?

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## Stress Testing the Estate Planning

- Continued stress test planning:
  - Have you documented the non-tax purposes for the entity?
  - Have you documented adequate and full consideration for the issued entity interests?
    - ❖ Contribution Schedule
    - ❖ Ownership Percentages
    - ❖ Capital Account Ledgers
  - Does client have books and records for the entity?
  - Are utilities in name of entity?
  - Are property taxes and other expenses being paid by the entity?
  - Is property liability insurance being paid by the entity?

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## Stress Testing the Estate Planning

- Continued stress test planning:
  - Is there any personal use of entity property?
  - Is there any comingling of entity assets?
  - Has client retained assets for own support and maintenance?
  - Do the partners conduct annual meeting and prepare minutes?
  - If children or trusts own entity interests, have gift tax returns been filed?
  - Are there prior sales or other non-gift transactions that have not been disclosed on prior returns?
  - Agent will request statement for operating accounts and search for non-disclosed gifts.

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## Stress Testing the Estate Planning

- Continued stress test planning:
  - Are parents supporting adult children?
  - Does client have Crummey letters for gifts?
  - If no Crummey letters, can you establish actual knowledge of gifts by beneficiaries?
  - Does a buy-sell agreement set a value or contain a put or call right?
  - Is there a potential IRC Section 6166 issue?
- If no, what can we do to backfill and fix the problems before it is too late?

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## Valuation Experts

- The core issue for most transfer tax cases is valuation so making the choice of an expert crucial to a positive outcome.
- Since tax cases can be tried in either Tax Court or through Refund Litigation, special attention should be paid to the forum in which the case may be tried. Traditionally, the vast majority of tax cases are resolved through the Tax Court, but increasingly refund litigation primarily in District Court is becoming popular.
- In Tax Court the expert's report is generally their direct testimony so you want to select a good writer who generates a very thorough report.
- In refund litigation, the expert will testify on direct and possibly to a jury so you want someone who is a good communicator and can explain complicated issues in a simple way.

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## Selecting A Valuation Expert

- Always choose an expert with the expectation that they will end up on the stand.
  - Find one that has some experience testifying.
  - Don't be shy about asking for past cases, redacted examples of reports and references.
  - Call the references.
- Don't be foolish about money, expect to pay for quality.
- Be cautious about hiring or anyone with a prior relationship to the client.
- Tie down who will testify in the event of litigation.

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## Rules for Handling Valuation Experts

- Always have the attorney retain the expert with a written fee agreement.
- Have all contacts go through the attorney; avoid client/expert interactions.
- Both you and the expert should keep a log of materials the expert sees.
- It is important for the expert to interview key witnesses and/or view the subject of the valuation.
- Maintain the privilege until you are satisfied with the expert's report.
- The attorney, CPA and client should carefully review drafts of the report for factual inaccuracy; do not hesitate to suggest revisions to insure completeness or readability. If everything goes wrong, it may be the basis for penalty defense.
- Do not push an expert past his/her comfort zone.
- If the expert appears to be moving toward an unacceptable solution do not hesitate to stop work and engage another expert.
- Don't urge a lower discount rate to appease the government.
- Always disclose negative factors so the expert can acknowledge them and prepare his/her report/testimony in anticipation. For example, are there unaccepted offers or post transfer sales to consider?

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## Transfer Tax Hot Buttons

- **Formula Clauses.** A properly drafted and followed formula clause in a will or gift transfer document can limit liability for estate or gift taxes. If the IRS or a court later redetermines the value of the transfer, the formula clause acts to adjust the amount of assets transferred to correspond to a specified dollar value.
- **Tax-Effecting Flow Through Entities.** Tax effecting is a valuation question effecting primarily S-Corporations. The argument is that S Corp earnings are subject to individual rates whether or not they distribute and that the additional cost should be factored into the valuation. This can result in a very significant additional discount, which of course the IRS opposes.

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## Marital Mismatch

- IRS argument: IRC Section 2036 includes the value of property previously transferred (i.e., undiscounted partnership assets), while the marital deduction is limited to the value of property actually passing to the surviving spouse (i.e., discounted partnership interest).
- Value mismatch between the inclusion of the partnership assets under IRC Section 2036 and the deduction of the discounted partnership interest under IRC Section 2056 resulting in estate tax on the first death.
- This is an inconsistent application of the Code.

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## Estate and Gift Tax Agents

- There are about 250 Estate and Gift Tax Agents nationwide. This means they are very understaffed and overworked.
- Some areas of the country have no local agents, which can be particularly problematic, because Estate and Gift Tax questions often turn on state law issues. For example, agents may be unfamiliar with mineral law or community property while examining Texas estate and gift returns.
- Examinations are assigned to offices nationwide based on workloads.
- Estate and Gift Tax Agents typically have few resources, which means it is unlikely that an agent will meet with a representative in person.

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## Tips for Working with Exam

- Verify taxpayer factual claims, especially those claims that appear to be too good to be true.
- Review the documents and look for any gaps or inconsistencies.
- Do not lie or mislead the agent.
- Never interpose your personal/professional reputation or veracity on behalf of a client.
- Maintain evidentiary privileges.
- Keep notes on all agent calls and contacts.
- Keep records of materials requested and produced or copied.

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## IRS Appraisers

- Estate and Gift Tax Agents routinely refer valuation matters to in-house appraisers.
- The process for the in-house appraiser can take 6-8 months and quality can vary. Some reports are very detailed while others have very little analysis.
- In litigation, the IRS typically retains outside appraisers. However, retention of an outside appraiser may depend on the time of year and the IRS budget.

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## Transfer Taxes and Appeals

- There are now a limited number of Appellate Officers that are qualified to consider transfer cases, nationwide. They appear to be geographically spread, but under unified management. 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 the Court of Claims.

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## Tips for Working with Appeals

- **Contents of the Protest.**
  - Address what is in the examination report.
  - Do not address issues not in the examination report.
  - Tell the story with a theme.
  - Use alternative arguments.
  - If you do not have enough time to file a complete protest, file a skeletal protest and supplement (but remember Appeals JAC).

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## Tips for Working with Appeals

- Be sure the appeals officer understands the facts.
- If the examining agent files a rebuttal report, ask for a copy.
- Never forget appeals' greatest strength: the ability to enter into risk of litigation settlements.
- File a Freedom of Information Act Request during or after the examination.
- Ask for a copy of the administrative file.
- Every meeting is a chance for discovery.
- Consider making a Qualified Offer to settle the case.

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## Tax Case Trials

- U.S. Tax Court
- Court of Federal Claims
- U.S. District Court

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Mr. Crouch is managing partner of Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP. For more than 30 years, he has counseled businesses and wealthy families and individuals about their most demanding tax planning, estate planning and IRS controversies. He often works with tax professionals and financial specialists to help develop solutions for their clients.

Mr. Crouch is board certified in tax law by the Texas Board of Legal Specialization and has been recognized as one of the best in his field by Texas Monthly and Law and Politics Magazines by being named a Texas Super Lawyer from 2003 through 2018. He has also been named one of the Best Lawyers in Dallas by D Magazine for the year 2012-2018 and he has also been named to Best Lawyers in America for Tax Law.

Mr. Crouch was recognized as a Top Rated Lawyer in White Collar Criminal Defense published in The American Lawyer, Corporate Counsel and The National Law Journal.

He is a frequent speaker on both substantive and procedural tax issues for both legal and accounting professionals. Topics include Tax Shelter Defense, IRS Examinations, Appeals, Litigation and Collection Strategies, IRS Criminal Investigations, IRS Offshore Activities, IRS Focus on Tax Professionals, Employment Classification, IRS penalties, and Litigating Partnership Tax Cases. Mr. Crouch has published various articles re: the IRS & tax procedures.

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