

Avoiding Gift and Estate Audit Triggers: Anticipating Audit Issues, IDRs, and Appeals

THURSDAY, OCTOBER 24, 2019, 1:00-2:50 pm Eastern

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Federal Estate Tax Returns: A Practical Overview

Keith Schiller, Esq.¹

Schiller Law Group,
A Professional Law Corporation
3201 Danville Blvd, Suite 285
Alamo, CA 94507
Tel: (925) 820-8500

E-Mail: kschiller@slg4law.com

Web sites: www.slg4law.com

www.EstatePlanningAtTheMovies.com

For information about the author's extensive textbook, as supplemented, *Art of the Estate Tax Return*, contact Innovative Estate Planning Productions, Inc., at the address above shown.

For additional information contact Andrea Townsend (atownsend@slg4law.com) or Kristen Kahawaiolaa (kkahawaiolaa@slg4law.com).

1 ☺☺ BONUS ALERTS FROM AN IRS GROUP MANAGER

The following is a list of common practitioner errors noted to this author **by an IRS Group Manager**:

- 1) Not attaching the entire appraisal. You paid a lot of money for it, attach the entire document. (See chapters 5 and 8 of *Art of the Estate Tax Return [herein referred to as "706 Art"]* published by Bloomberg BNA Books and Innovative Estate Planning Productions, Inc., as supplemented.)

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- 2) Not checking for gift tax filings when preparing an Estate Tax Return or current year Gift Tax Return. (See *chapter 6 of 706 Art*, as supplemented.)
- 3) Not providing information about an item listed on a tax return. For example, I often see a large debt to the Bypass Trust on the return for the surviving spouse. No narrative is provided explaining why the survivor owes money to a Trust paying out to that spouse. Usually it is for lack of trust funding but they don't say that. (See *chapters 14 and 19 of 706 Art*, as supplemented.)
- 4) UNSIGNED documents. Wills, Trusts, assignment documents. Anything that has a signature line. I really, really dislike that. (See *chapter 4 of 706 Art*, as supplemented.)
- 5) Failure to Adequately Disclose a Gift on a current year Gift Tax Return. I still see this even though the law changed over 20 years ago. Paid preparers filing a 5-page return with ZERO attachments. (See *chapter 6 of 706 Art* as supplemented.)
- 6) Taking losses on part 1 of Schedule L that are not really losses. Example: Value of real estate declined from the valuation date and taking that as a loss on Schedule L. (See *chapter 20 of 706 Art*, as supplemented.)
- 7) Not attaching a nice, long narrative for the QTIP election to Schedule M. This is done more by CPAs and not attorneys. I think a nice narrative, citing the Trust document, is the best way to go. (See *chapter 21 and the chapters including illustrated estate tax returns for the death of the first spouse in 706 Art*, as supplemented.)
- 8) Filing for an extension, making a good estimated payment, but failing to ask for time to pay in case the estimate was low. I am seeing this all the time now. Ask for 6 months to pay just in case you are low on the estimate. (See *chapter 2 of 706 Art*, as supplemented.)
- 9) Estimating the deduction for selling expenses but not selling the property at the time of filing. Also, taking a selling expense deduction (when paid) with an attitude that all expenses are deductible without considering the rules under the 2053 regulations. (See *chapter 18 of 706 Art*, as supplemented.)

2. Gathering information

Review instructions to the estate tax return and each schedule.

Appraisals have very specific requirements. Expert appraisers should include these in reports. The competent ones do.

Also practical general information gathering:

- Review of 3-5 years income tax returns
- Review of 1-3 years of bank records (general ledger)
- Five years of financial statements of businesses

- All gift tax returns
- Insurance declarations
- Inquiry into potentially relevant conditions on properties.
- How did loved ones acquire major assets and interests?

TABLE OF CONTENTS

The table of contents used by the author typically uses the following format:

- certified copy of the will;
- certified copy of the death certificate;
- copy of the application for time to file/pay estate tax;
- copies of gift tax returns;
- a statement to explain differences, if any, between the total of adjusted taxable gifts reported on line 4 and the total of adjusted taxable gifts arising from gift tax returns filed by the decedent or the executor on behalf of the decedent;
- a copy of the work paper for line 7 (sample provided in the instructions to Form 706) for the computation of the estate tax credit for gift taxes paid on gifts made after December 31, 1976;
- a statement supporting any restoration of the exclusion amount and/or GST exemption in the event that Notice 2017-15 applies, and insert “FILED PURSUANT TO NOTICE 2017-15” on the top of the return if it does apply;
- evidence of payment of state death taxes;
- Protective Alternate Valuation Date Election;
- if an election under Code §6163 is made to postpone the payment of federal estate tax as a result of a reversion or remainder interest in the gross estate, then attach a duplicate copy of the letter and information previously submitted to the IRS (at the address to which estate tax returns are filed);
- if an election is made to defer the estate tax under Code §6166, attach a copy of the notice with computation and supporting statements;
- explanation of why life insurance is not included in the gross estate with a copy of the life insurance trust;
- Exhibit A: all attachments relative to real estate and its valuation (the instructions to Schedule A direct that real estate owned in a revocable living trust should be reported on Schedule G);²

² In the event that the real estate is subject to adverse conditions, including but not limited to easements, non-conforming uses, hazardous waste and other toxic or environmental conditions, asbestos, underground storage tanks, recent deaths on the property, litigation, and other limitations or conditions and they impact value, then a description of these items should be included in the appraisal of the real estate together with supporting evidence, sub-expert reports, and other documentation to support the

- Exhibit A-1: when this election is made, the attachment of all required documents, appraisals, and the agreement in part 3 of Schedule A-1;
- Exhibit B: all attachments relative to stock and securities (and consider whether to use reliable third-party sourcing companies such as EstateVal and whether to itemize each publicly-traded security in the body of Schedule B or include them in an attachment). See Comment in relation to Form 8971 and Schedule A;³
- Exhibit C: all attachments relative to cash (which usually is not much unless a note is appraised);
- Exhibit D: Form 712 for each policy (and a copy of each life insurance trust with respect to policies of insurance on the life of the decedent) and explanation of any mistakes in the Form 712 that the insurance company does not correct prior to filing the estate tax return;
- Exhibit E: all attachments relative to joint tenancy property and its valuation, including affidavit of contribution by surviving joint tenant on non-qualified joint tenancy property and appraisals;
- Exhibit F: all attachments relative to this schedule (there may be many, because this is a very diverse schedule);
- Exhibit G:
 1. copy of the living trust (because of the expansive use of living trusts, this schedule is often the longest asset schedule),
 2. all documents applicable to the respective asset and its valuation as would apply to reporting under Schedules A, B, C, or F,
 3. in the event that gift tax was paid by a donee under a net-gift or net-net-gift arrangement, attach a copy of the agreement obligating the donee, and
 4. attachment of transfers during life of decedent that are not part of the gross estate under Schedule G (see first paragraph of instructions to Schedule G);
- Exhibit H:
 1. a copy of the trust in which the decedent holds a general power of appointment,
 2. the appraisals of assets with respect to the trust referenced in item H(1),
 3. a copy of the trust in which the decedent holds a 5/5 power that lapsed on the death of the decedent, and

adjusting factors on the issue of valuation. The use of a qualified appraisal constitutes best practices.

³ Generally list securities separately especially if Form 8971 and Schedule A are required. Limited exceptions under that form for the use of attachments. Attach full appraisal reports. The use of a qualified appraisal constitutes best practices. If an appraisal is not used, then attach five years of operating statements and other financial evidence of value.

4. the appraisals of assets with respect to the trust referenced in item H(3).
- Exhibit J:
 1. copy of funeral related bills and expenses to transport the body,
 2. if preferred to be filed with the estate tax return, the statement under Reg. §1.642(g)-1 waiving the income tax deduction for the items reported as deductions on the estate tax return, and,
 3. copies of documents supporting unique or non-obvious items;
 - Exhibit K: copies of documents supporting unique or non-obvious items;
 - Exhibit L:
 1. proof of casualty loss with supporting explanation and documentation, and
 2. support for deductions applicable to assets not subject to creditors claims;⁴
 - Exhibit M:
 1. a list, if applicable, of marital deduction gifts (attach flexibility language that expresses the marital deduction formula to provide desired result in the event valuations, deductions, adjusted gross estate, or other elements relative to the election vary from amounts shown on the return),
 2. in the event of a QDOT election, a copy of the assignment of any transfers that were originally not in trust, security if the trustee is not a U.S. Trustee, court order in the event of reformation, and other required attachments, and
 3. a copy of the qualified disclaimer in the event relevant to the marital deduction reported;
 - Exhibit O:
 1. proof of exemption for charitable organization, particularly if not well known,
 2. a copy of any court order approving distribution, if applicable, and
 3. a copy of trust if not already attached per another schedule,
 - Exhibit R: attachment, including flexibility language, regarding GST exemption allocations;
 - Exhibit U: appraisals (also, a worksheet, if required, due to difference in relevant valuation dates) and a copy of the easement agreement subject to development rights in accordance with the instructions (see §26.3.5 of *706 Art*, as supplemented);
 - Schedule PC: Schedule PC when protective refund claims with respect to administrative expense deductions and claims under Code §2053 are

⁴ Do not list administration expense deductions applicable to living trusts on Schedule L. Rather, include them on Schedule J, unless the trust estate is not subject to creditors' claims.

filed with the estate tax return (a separate Schedule PC is required for each item of the protective refund claim and must be filed in duplicate);⁵ and

- A letter requesting prompt assessment under Code §2204 or file request for certificate.

3. Practical recommendations to avoid liability claims with the most complex return your clients may ever file.

- A. Define responsibilities in the engagement agreement, including identification of professionals responsible to prepare the estate tax return; and exclusions of other tax-advice and return preparation or review if that is the case.
- B. Estate tax returns are fundamentally issue-driven (i.e., art) in which the facts are marshaled and analyzed ... and if need be developed before the estate tax return is filed... to fit desired results to the extent allowable. Issues and elections missed lead to claims.
- C. Approach estate tax returns as a collaborative effort:
 - 1. Work with quality CPAs and appraisers.
 - 2. Have an attorney or tax practitioner highly experienced with estate tax returns review the return before filing.
 - 3. Do not accept engagements that you believe may be unduly troublesome. The best protection for the practitioner is to respect your “antenna” and respect that some potential clients are best served elsewhere.
- D. Identify appraisers and start appraisal process early.
- E. If you do not feel very, very confident with you legal, tax and practical knowledge with estate tax return preparation, do not prepare estate tax returns.
- F. Consult with appropriate practitioners in other states/nations when dealing with death taxes and property rights on which the laws of other states and nations have bearing. Be on the lookout for death tax return requirements for those jurisdictions and evidence of proof of foreign death tax.
- G. Late or blown elections are a major source of claims.
 - ☺ Protective elections can be excellent safeguards.
 - ☺ Insert formulas, not just numbers to recite what you want.

⁵ See, Rev. Proc. 2011-48, and §18.5 of the Main Volume of 706 Art.

- H. Late payment and late filing penalties are horrid. File timely. Also, some elections are lost if the return is not timely filed. (IRC Sec. 6166 and portability on required returns are primary culprits.)
- ☹ 5% per month, total 25% late filing penalty for each month late based on tax payable
 - ☹ .5% per month late payment penalty with maximum of 25%. Interest is not added to this penalty
 - ☹ Valuation understatement penalties: Substantial understatement: if the value of any property claimed on the estate or gift tax return is 65% or less of the amount determined to be the correct valuation—20% penalty of the portion of the tax attributable to the undervaluation, with a bump in the penalty percentage to 40% in the event of a “gross valuation” misstatement (i.e., 40% or less of the amount determined to be correct.)
 - ☹ 5% negligence penalty
 - ☹ 75% fraud penalty
- I. Some of Keith Schiller’s common reminders:
- a. Ascertain existence of prior gifts:
 - i. Review available files;
 - ii. Check with prior advisors, review income tax returns for at least 3 years prior to death; and
 - iii. Request transcript from the IRS of gifting history! ☺☺☺
 - ☹ <https://www.irs.gov/individuals/get-transcript> (January, 2018). Requests for a return transcript can be made by Form 4506-T (preference of IRS) electronically or by mail. Note that gift tax returns in the 1970’s were filed quarterly. Need to specify each quarter when using Form 4506-T. Use Form 4506 to obtain copy of a return.
 - b. Adjusted taxable gifts: Review gift reporting prior to 1997 for over-valuation, particularly with partial or minority interests. TAM 9718004. ☺☺
 - c. ☺ When a QTIP trust is part of the “play,” extend the time to file and pay: 6 months to file and 12 months to pay federal estate tax (FET). Rev. Rul. 59-9.
 - d. Extend time to file on portability elections (and pay if FET is possible).
 - e. Incorrect Alternate Valuation Date (AV Date) elections. Valuations needed on all valuation dates. All-or-nothing election.

- f. Ages of non-family on generation-skipping transfer tax (GST) transfers (generation assignment).
- g. Dealing with difficult estate tax attorneys with the IRS.
- h. Reduced time to send case to appeals... keep audits moving.
- i. Credit for gift tax on estate tax return.
- j. Review trust funding and file creditor claims if exemption trust underfunded.
 - ☹ **Alert: Creditor Claims must be timely filed under state law.**
- k. Watch out for timing traps and inane requirements for protective refund claims under Code Section 2053. Rev. Proc. 2011-48.
- l. Be alert for the character of debt, which may be significant on several issues: (1) valuation (assumable or not and FID), (2) qualification for elections based on percentage of the adjusted gross estate.
- m. Discounts and how to lower them on the death of the first spouse. (Discussed in chapter 8 of *706 Art.*)
- n. Reporting basis consistency and the new Form 8971 and Schedule A.
- o. Reporting *paid* versus *estimated* administrative expenses on Schedule J and recent special audit pilot project of IRS with estimated expenses.
- p. Protective refund claims and later actual refund claims timely filed and properly prepared. Rev. Proc. 2011-48. **Major issue if the case is not resolved in audit or all expenses and liabilities are not paid and effectively deducted on an estate tax return within three years of initial filing of the return.**

4. Valuation and Appraisals

7.1 Objective Standard and Its Perversion: Reg. §20.2031-1 or Reg. §25.2512-1. Objective standard and 9th Circuit cases are strong on this point. Some recent Tax Court Memorandum decisions have not followed the objective standard in that they assumed particular buyers. See, *Estate of Guistina v. Comr.*, T.C. Memo 2011-141 and *Estate of Ludwick v. Comr.*, T.C. Memo 2010-104; and *Estate of Elkins v. Comr.*, 140 T.C. No. 5 (2013).

7.2 Focus: The initial focus will want to be on underlying value, *not* discounts. *Estate of Pillsbury v. Comr.*, T. C. Memo 1992--425, *Estate of Desmond v. Comr.*, T. C. Memo 1999-76; *Estate of Hall v. Comr.*, 92 T.C. 312 (1989); *Baer Rev. Trust v. U.S.*, 2010-1 U.S.T.C. ¶60,590 (D.C. Neb.); *Estate of McGill v.*

Comr., T.C. Memo 1984-292; *Estate of Richards v. Comr.*, T.C. Memo 2012-173 (taxpayer favorable).

7.3 Post-death Facts: Working with appraisers; issues of relevancy under objective standard. See, *Estate of Edwards v. Comr.*, T.C. Memo 2001-229 (post-death leases not considered); *Estate of Desmond v. Comr.*, *supra*, post-death events actually helped the taxpayer when a sale made 20 months after death was used to lower valuation under a finding that the events had not changed since the time of death; and, *Levy v. U.S.*, 402 Fed. Appx. 979 (5th Cir. 2010) *cert. denied* 131 S. Ct. 2914-(2011) (zoning changes considered foreseeable and sale of the property not too remote in time). Thus, in *Estate of Newberger v. Comr.*, T.C. Memo 2015-246, the sale of a Picasso painting substantially in excess of the appraised value and amounts estimated by the auction house was held to reflect fair market value, adjusted downward to the date of death conditions; *Estate of Jung v. Comr.*, 101 T.C. 412 (1993) distinguished between a post-death sale that *affects* the market value and a post-death sale that *evidences* the market value; *Morrissey v. Comr.*, 243 F.3d 1145 (9th Cir. 2001), *rev'g Estate of Kaufman v. Comr.*, T.C. Memo 1999-119, the Court of Appeals used actual sales of minority interests of closely held stock to determine the value of the largest outstanding block (a 20% holding) in the largest manufacturing company of uniforms in the nation; See, *Estate of Pulling v. Comr.*, T.C. Memo 2015-134 in which unfounded assumptions were not acceptable to the court to combine adjacent lots to add an assembly premium to the value of each lot.

8.4 Engage Appraisers Appropriate to the Job. Going cheap on appraisal engagements can be an expensive decision. The author does NOT recommend the use of probate referees unless the probate referee is also a qualified appraiser and provides a full appraisal report. The inventory and appraisal is not sufficient (except perhaps with a portability-only return in an estate without beneficiary conflict). Ascertain experience level and use appraisers who are members of recognized associations (such as AIA or MAI).

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