

# New Jersey Law Journal

VOL. 204 - NO 8

MAY 23, 2011

ESTABLISHED 1878

IN PRACTICE

## TRUSTS & ESTATES

### Dot Your I's and Cross Your T's

Preparing for the inevitable estate tax audit

BY TARA S. SINHA

It is possible that virtually every 2011 estate tax return resulting in the payment of federal estate tax will be audited by the Internal Revenue Service (IRS). On Dec. 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Among other provisions, the law increases the federal estate tax filing threshold to \$5 million for persons dying in 2010 through 2012. The ABA's Real Property Trust and Estate Law Section estimates that less than one-half of one percent of people who die in 2011 will be subject to the federal estate tax. Another estimate projects that only 3,600 estates will pay the estate tax in 2011 under the new tax scheme. With so few filings, every estate tax return will likely be scrutinized.

Therefore, the question becomes, how do we, as trust and estate lawyers, prepare our clients for the inevitable audit? Following are ways we can assist our clients in preparing for a tax examination, and actions we can take as estate planners to minimize their exposure on audit.

---

*Sinha is an associate at Witman Stadtmauer in Florham Park. Her practice is focused on estate planning and administration.*

#### Gift Issues

Once an estate tax return is filed, the IRS confirms that all gift tax returns filed by the decedent are reflected on the estate tax return. Therefore, it is imperative to know whether the decedent filed any gift tax returns. Confirm with the decedent's accountant whether any gift tax returns were filed; if so, make sure that the estate tax return reflects any inter vivos adjusted taxable gifts (gifts made during the decedent's life in excess of the annual gift tax exclusion). If the decedent did not have an accountant, or the accountant is unsure if returns were filed, copies of the decedent's gift tax returns can be requested from the IRS.

Any gift tax returns filed by the decedent should also be inspected to make sure that the gift was adequately disclosed. If the gift is not "reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported," Treas. Reg. 301.6501(c)-1, the statute of limitations may not have begun to run upon the filing of the return. This may result in the gifts reported on the gift tax return also being subject to IRS examination during the estate tax examination. The Regulations set forth the criteria for "adequate" disclosure.

Gift tax returns should also be reviewed to determine whether the decedent used any portion of her lifetime

generation-skipping transfer (GST) tax exemption. Although GST tax and allocation issues are beyond the scope of this article, decedents dying in 2011 and 2012 have a \$5 million GST tax exemption, which can be utilized during their lifetime or at death. If the decedent makes a testamentary GST bequest, for instance a bequest to a grandchild, an executor must know how much of the decedent's GST exemption remains at her death. If the decedent made GST gifts during her lifetime, such transfers should be reported on a gift tax return.

Many clients establish irrevocable life insurance trusts (ILITs) to hold policies insuring their lives. Typically these clients pay the premiums on these policies by making contributions to the ILITs and utilizing Crummey beneficiaries to qualify such contributions as present interest gifts. On audit, the IRS could ask for documents to prove a decedent trust grantor fulfilled all the requirements of a Crummey trust — copies of checks evidencing contributions to the ILIT, copies of the checks from the trust to the insurance company, copies of Crummey letters sent to beneficiaries, and copies of refusal letters signed by Crummey beneficiaries. Many clients ignore the formalities of a Crummey ILIT; however, in an environment where every aspect of an estate can be scrutinized on audit, it is important that practitioners stress to clients that they take these steps.

Clients are making intra-family loans to their children to take advantage of the low applicable federal rates (AFR), which may later be forgiven as part of an annual gift program or upon

the parent's death. Many clients do not observe the formalities of these loans, for instance not executing written promissory notes or failing to collect the loan's annual interest. Neglecting these steps may become problematic in an estate tax examination if the auditor determines that the failure to observe these requirements results in the loan being characterized as a gift.

#### **Proper Asset Valuation and Reporting**

Failing to properly value the decedent's assets can give rise to a variety of issues in an estate tax audit. The tax preparer should value stocks by taking the mean of the high and low values on the date of death, rather than the closing price. The return should reflect accrued interest or dividends declared but not yet received. A preparer should be familiar with the IRS reporting requirements and standards for proper valuation of the decedent's assets.

For property that is difficult to value, such as real property or interests in closely-held businesses or family limited partnerships, appraisals are generally required. However, the appraisal must withstand the scrutiny of an audit. Is the appraisal specific to the decedent's holdings or is it generalized with boilerplate language? Are comparable holdings truly comparable assets? If discounts are applied, does the appraiser provide a rationale for the discounts? Practitioners should review appraisals ensuring that they are complete and accurate. If you cannot understand the appraisal and justify its methodology, you cannot defend it on audit.

The practitioner should make sure the estate tax return reflects all of the decedent's property. Examining the de-

cedent's income tax returns will provide guidance regarding her holdings, including assets generating interest or dividends and interests in partnerships or corporations. If there is an institution listed on Schedule B of the decedent's income tax return that is not on the estate tax return, the practitioner must be able to explain why (i.e., the account was closed before death). Reviewing three years of the decedent's income tax returns will allow a "self-audit" to determine whether any assets are missing. Furthermore, the amount of interest or dividends reported on Schedule B should be commensurate with the date of death value of the asset. If an account is generating thousands of dollars of interest but has a nominal date of death value, further investigation is warranted.

Inquire whether the decedent owned a car, jewelry, art or collectibles. A preparer should review the decedent's homeowner's insurance policy, including riders, to determine if such property is reflected. The decedent's tangible personal property must be reported and the value should reflect the decedent's standard of living. For example, it is unrealistic to believe that a decedent with a personal residence and vacation home each valued in excess of \$1 million would possess tangible property only valued at \$400. An auditor viewing such an unlikely valuation may question the valuation of other assets, increasing the intensity of the audit.

#### **Deductions and Expenses**

A federal estate tax deduction is allowed for state estate taxes paid. The IRS can request evidence of actual payment of state taxes; therefore, it is important that this deduction be properly calculat-

ed. Executor's commissions and accountant and attorney fees are also permissible estate tax deductions. Upon audit, the IRS will seek proof of payment of these deductions. If debts are claimed on Schedule K of the estate tax return, the IRS may require proof that the amounts were outstanding on the date of the death and not expenses that arose subsequently. A practitioner should confirm the validity and proper reporting of deductions and debts. If such expenses are unusually large, the practitioner may consider pre-emptively submitting documentary evidence.

If bequests are made to charities, confirm that the organizations are tax exempt. The Internal Revenue Manual instructs examiners to "determine that a charitable deduction will be used for a charitable, public or religious purpose," noting that "[a] bequest to an organization that is exempt for income tax purposes may not qualify for an estate or gift tax charitable deduction."

It is not possible within the confines of this article to provide a conclusive list of the issues that may be encountered in an estate tax audit. However, some of the common issues and errors that should be avoided in preparing estate tax returns have been highlighted. If the experts are correct, and nearly every taxable federal estate tax return will be audited, there may be little practitioners can do to prevent an audit. However, it is our job to put our clients in the best possible position to withstand the scrutiny of an examination, including preparing a complete and accurate return and obtaining supporting documentation for all reported assets and liabilities. By doing so, we can most effectively help our clients negotiate the examination process. ■