GIFT TAX AUDITS EXPECTED TO INCREASE IN THE FUTURE?

Taxpayers Filed 258,393 Gift Tax Returns in 2012

The IRS 2012 Data Fact Book reports that 258,393 gift tax returns (Forms 709) were filed that year compared to 219,544 in 2011. The most striking difference between the two years is the aggregate amount of the gifts which totaled about $135 billion in 2012 reflecting an increase of $84 billion, or 165%, over the 2011 total of $51 billion. It should be noted that many 2012 gift tax returns were filed in 2013 because the IRS allowed the taxpayer to submit Form 709 by October 15, 2013.

Will the IRS Audit Gift Tax Returns Filed in 2012 and 2013?

Although only 3,164, or 14.2%) of the 2012 gift tax returns were audited, many professionals expect the IRS to step up its audit efforts during the next few years based on the Service's goal to increase its income.[1] Furthermore, the Service has more resources available to devote to the voluminous gift tax returns filed in 2012 as a result of a dramatic decrease in estate tax filings attributable to the high estate tax, gift tax and generation-skipping transfer tax exemption amount which is in excess of $5 million for each spouse.

What Are Common Factors That Trigger an Audit of Form 709?[2]

- Failure to answer all the questions on the return.
- Failure to attach all the required documents to the return.
- Failure to form entity (corporation, limited partnership, limited liability company, etc.) for a business purpose.[3]
- Applying valuation discounts but not attaching an appraisal.
- Errors in reporting jointly owned property.
- Excluding personal property or undervaluing personal property.
- Controversial technical tax issues that are apparent from the return, such as marital deduction issues, foreign assets, and closely held businesses.
- Math computation errors or internal inconsistencies.
- The overall appearance of the return, if the return is sloppy or has a less than professional finished appearance, the implication to the auditor is the possibility that the substance of the return was also careless.

[1] Although the statute of limitations applicable to gift tax returns is three years, the term may be extended by agreement of the taxpayer and the IRS.

[2] "Overview of Estate and Gift Tax Audits" written by Jennifer A. Pratt, published in the Maryland Bar Bulletin in September 2011.

[3] See Internal Revenue Code Section 2036.

What is the Audit Process?

Case Study: IRS Challenges the Value Conclusion for a Non-Controlling, Non-Marketable Membership Interest in a Limited Liability Company ("LLC") Rendered by a Business Appraiser.

Below is an overview of the progression of events which typically occur during the course of a gift tax audit.

- The taxpayer is represented by his attorney or accountant "Professional").
- An IRS attorney ("IRS Attorney" or "IRS") mails an audit notification letter to the taxpayer or tax preparer informing him that the IRS is in the process of examining the gift tax return.
- Examples of information solicited in the notification letter are the date of formation of the LLC; income tax returns; documentation of members' capital accounts; dates and amounts of capital contributions and distributions; assignments; and the nature of the LLC's operations.
- After reviewing the requested data, the IRS Attorney will either agree with the value included on Form 709 and issue a "no change" letter or challenge the appraiser's opinion of value.
- If the tax liability is significant, the IRS may submit its own valuation of the membership interest to the Professional.
- The IRS Attorney next presents a settlement offer to the Professional which is usually considerably lower than the value conclusion in the appraisal report.
- If the parties cannot reach an agreement regarding the value conclusion, they can take advantage of the Fast Track Settlement ("FTS") procedure (Revenue Procedure 2003-40) or the Fast Track Mediation ("FTM") process (Revenue Procedure 2003-41).
- FTS was enacted to resolve disputes between the taxpayer and IRS through the mediation process within 60 days of acceptance of the FTS application. If a resolution is reached, FTS requires the taxpayer and the IRS to sign a consent form acknowledging acceptance. A key component of the FTS is that the taxpayer does not give up any of his rights and can withdraw from the mediation process at any time. Issues not resolved can continue to be negotiated through the IRS Office of Appeals.
- FTM enables taxpayers to resolve disputes with the IRS within 40 days. With FTM, a trained mediator from the IRS Office of Appeals is assigned to the case with the intent to settle the disputed issues. The taxpayer retains full control over every decision made throughout the FTM process and no one can impose a decision on either party.
- If the taxpayer and his Professional are not satisfied with the direction in which the negotiations are heading, regardless of whether or not they took advantage of the FTS or FTM options, they can file a protest with the IRS Appeals Division or plead their case

administratively within the IRS, to the U.S. Tax Court, U.S. Court of Federal Claims or the local U.S. District Court.

- If there is no agreement at the closing conference with the Appeals examiner, the taxpayer and his Professional have 30 days to consider the Service's proposed adjustments and their next course of action. If the taxpayer does not respond within 30 days, the IRS issues a statutory notice of deficiency, which gives the taxpayer 90 days to file a petition to the United States Tax Court.[4]
- The last action available to the taxpayer is to litigate the tax matter in the US Tax Court, which provides a judicial forum in which the IRS and taxpayer can dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to payment of the disputed amounts.
- Trials are conducted before a judge[5], without a jury, and taxpayers are permitted to represent themselves if they desire. However, the vast majority of cases are settled by mutual agreement without the necessity of a trial. However, if a trial is conducted, in due course a report is ordinarily issued by the presiding judge setting forth findings of fact and an opinion. The case is then closed in accordance with the judge's opinion by entry of a decision.

Are You Anticipating Audit Notification Letters?

We have spoken to dozens of estate planners and accountants during the past year who tell us that very few or none of their client's 2012 and 2013 gift tax returns have been audited. Do you think the floodgates will open soon?

By Gary Ringel

[4] The Claims Court and District Court generally do not hear tax cases until after the tax is paid and administrative refund claims have been denied by the IRS.

[5] The Tax Court is composed of 19 judges appointed by the President of the United States and confirmed by the Senate, according to http://ustaxcourt.gov/about.htm. .