THE NATIONAL LAW REVIEW

High Probability of Estate Tax Audit Necessitates Advance Preparation

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Monday, January 13, 2014

Most individual taxpayers are fortunate enough to never have to endure a painful interaction with the IRS beyond filing their personal income tax returns. Budgetary pressures in recent years have constrained the IRS's ability to devote significant resources to effective routine enforcement of individual income tax return filings. But the low "audit coverage" in the individual arena is not reflective of the scrutiny for **estate tax return filers.**

Significant IRS Interest in Estate Tax Returns

Every taxpayer expecting to be subject to a federal estate tax return filing requirement faces the high probability of audit. The number of estate tax returns has dropped dramatically over the past few decades, in part due to the increasing exclusion amount that negates the need to file a Form 706, "United States Estate (And Generation-Skipping Transfer) Tax Return." While the unified credit against estate tax once stood at only $1 million in the early 2000s, Congress has repeatedly raised the credit amount in successive estate tax legislation; the current exemption amount is $5,250,000 per individual.

As a result, the number of estate tax returns has plummeted over the past decade, from over 70,000 returns filed for the 2003 tax year to less than 10,000 returns for 2011. This has enabled the IRS to use its existing estate tax personnel to look at a higher percentage of filed estate tax returns.

IRS employees in the Service Center go through each filed Form 706 manually and handpick which returns are selected for audit. According to the IRS Statistics of Income Bulletin, in fiscal year 2012, the agency had an audit coverage rate of 30 percent for estate tax returns. The IRS reviewed 3,762 returns out of 12,582 filed returns. Of importance to estate tax filers is the IRS recommended $1.14 billion in additional tax owed from the audited returns, with an average of $304,500 additional tax due per return. Large estate tax returns received even higher scrutiny: returns for estates with valued assets between $5 and $10 million had an audit rate of 58 percent in fiscal year 2012, while returns with assets higher than $10 million were audited at a 100 percent rate. Thus, estate tax return filers with assets in excess of $10 million can expect an audit in every circumstance.

FISCAL YEAR 2012 IRS EXAMINATION OF ESTATE TAX RETURNS					
Estate Size	# of Returns Filed	Returns Examined	Audit Rate	Recommended Additional Tax (in thousands)	Average Recommended Tax Per Return
Under $5M	9,404	1,362	14.5%	$ 116,748	$ 85,718
$5 - $10M	2,241	1,313	58.6%	$ 138,375	$ 105,388
Over $10M	937	1,087	116.0%	$ 890,517	$ 819,243
Total	12,582	3,762	29.9%	$ 1,145,640	$ 304,530

These statistics emphasize that high net-worth taxpayers need to carefully plan their estates in conjunction with competent tax professionals in order to ensure that any likely audit by the IRS is not only handled appropriately, but that the issues reviewed by the government are adequately documented and can survive intense scrutiny. The IRS is under pressure to reduce the tax gap, and estate tax returns offer a convenient avenue for the agency to assert additional tax due if the return presents issues that an IRS agent can challenge.

Numerous Pitfalls Possible

There are numerous steps in the estate planning process that can eventually lead to disputes with the IRS if the taxpayer and the estate planning professional are not vigilant. It is advisable to engage a tax professional to ensure that the planning process contemplates potential audit issues to adequately prepare for interactions with the IRS after a return has been filed.

Areas that the IRS often focuses on in an estate tax audit include:

- valuations of property and business interests;
- discounted valuations of assets;
- unreported and undocumented gifts;
- potential conflicts among advisers and return preparers; and
- documentation of inter-family transfers.

Valuations of property that form the basis of a trust, charitable gifts, or business succession strategies are highly susceptible to attack by the IRS if technical rules are not precisely followed. Likewise, the discount rates applied to transfers of interests in family limited partnerships and closely held businesses are frequently challenged by the IRS, requiring the use of experts and production of extensive financial and business documentation. New valuation report requirements for certain assets in the Code add new challenges for filing an estate tax return.

The IRS often tries to disallow deductions for interest paid when the estate borrows funds from a closely related business entity in order to pay the estate tax. Also, the existence of unreported gifts sometimes arises during audit of an estate tax return. And it may not always be obvious to a client or adviser that conflicts of interest are present among potential parties when a plan is being implemented. A tax professional can provide guidance on these issues so that a decedent's return is prepared and filed with proper documentation while following the legal requirements of the transactions reported on the estate tax return.

Key Take-Away

Anticipating challenges to an estate tax return is a reality in today's environment and advisers need to prepare their clients. Adding professionals familiar with issues surrounding estate tax audits into the estate planning process may reap long-term benefits by anticipating potential issues should the IRS carefully review an estate tax return searching for additional revenue.