Estate & Gift Update Part 2: Pitfalls When Handling the Estate and Why the Tax Returns Matter!

2022 IRS Representation Conference

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Ms. Ziering's practice focuses on representing individual and entity clients in civil and criminal tax disputes with federal and state governments as well as in regulatory proceedings.

She defends both individual and entity taxpayers before the U.S. Tax Court, federal and state courts, and administrative agencies, including the Internal Revenue Service, the Department of Justice, and other federal and state government regulators.

Ms. Ziering advises taxpayers in connection with various tax issue, including those arising in connection with domestic and offshore income and assets, cryptocurrency, and U.S. tax and regulatory reporting requirements.

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Frank Agostino, Esq.,
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Frank Agostino is the founder and president of Agostino & Associates, P.C. Prior to entering private practice, Mr. Agostino was an attorney with the Internal Revenue Service's District Counsel in Springfield, Illinois and Newark, New Jersey. He also served as a Special Assistant United States Attorney, where he prosecuted primarily criminal tax cases. As an adjunct professor, Mr. Agostino taught tax controversy at Seton Hall University W. Paul Stillman School of Business and Rutgers School of Law. He also served as the co-director of the Rutgers Federal Tax Law Clinic.

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Mr. Freeman is the founding member of Freeman Law, PLLC. He is a dual-credentialed attorney-CPA, author, law professor, and trial attorney.

Mr. Freeman currently serves as the chairman of the Texas Society of CPAs (TXCPA). He is a former chairman of the Dallas Society of CPAs (TXCPA-Dallas). Mr. Freeman also served multiple terms as the President of the North Texas chapter of the American Academy of Attorney-CPAs. He has been previously recognized as the Young CPA of the Year in the State of Texas (an award given to only one CPA in the state of Texas under 40).

Mr. Freeman serves on the law school faculty at SMU's Dedman School of Law, where he has taught a course in the law of federal income taxation for nearly a decade, and he is a frequent public speaker across the country, presenting and educating on various legal topics.

Introduction

ALL estate tax returns will be reviewed for audit potential

Limited scope examinations	Limited focus examinations	Project cases	Normal audit

Estate and gift returns generate more tax dollars per capita than any subdivision of tax.

Fraud by the decedent or personal representative (PR) is increasingly examined

Estate tax audits and investigations require preparation and strategy

Addition scrutiny from State AG if charities are beneficiaries

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Hypothetical 1

- Decedent died in 2012 with an estate value well below $5,120,000 (filing threshold in 2012). As a result, the Federal Estate tax return was not required to be filed.
- Under the Will, the decedent, who did not have any direct heirs, left a few specific bequests to friends and remainder to charities. All the assets were liquidated and/or distributed in accordance with the Will.
- In 2014, a letter arrived from a Swiss bank participating in the DOJ bank program stating that the bank is closing the account and encouraging the decedent to participate in the voluntary disclosure program. The value of the account is $10,000,000.
  - What should the executor do? What options are available?
  - Would it make a difference if the Estate tax return was already filed?
  - What about decedent's tax returns? Estate's income tax return? FBARs?
  - How about the State?
  - Any concerns about beneficiaries?
  - What if the penalties assessed on the estate exceed the value of the estate? Can the bequests be clawed back?

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Hypothetical 2

- Decedent passed way suddenly in a tragic accident, without a Will. The widow believes that her husband acquired some cryptocurrencies a few years ago but does not know anything else about it. After a diligent search, the executor cannot find any record of the cryptocurrency, or its acquisition and disposition and files the estate tax return accordingly.
  - What other steps can executor take to protect themselves, estate and heirs from potential liability should the missing cryptocurrency subsequently surface?
  - If the estate tax return is audited, how should the executor handle this issue?

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Begin With the End in Sight…

- Before responding to the first, information document request, know what the Internal Revenue Service knows (and more)
  - Review Transcripts of Account;
  - Review FOIA responses;
  - Stock books;
  - Review national and international deed and asset searches;
  - Income tax returns;
  - Bank statements; and
  - Third-party information.

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Civil Fraud by the Decedent and the Executor – Defined and Basics

- Civil Tax Fraud
  - Defined: "The term 'fraud,' as used in the statutory provisions authorizing the assessment of civil fraud penalties against taxpayers, means intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing." Gagliardi v. United States, 81 Fed. Cl. 772, 777 (Fed. Cl. 2008).
  - Elements: To prove civil tax fraud, the following must be proven by *clear and convincing evidence* for reach return at issue:
    - An understatement of tax; and
    - Fraudulent intent (i.e., that the offender intended to evade taxes known to be owing by conduct intended to conceal).
  - Consequences of a Civil Tax Fraud Assessment:
    - The Code imposes a 75% penalty on the portion of any underpayment of tax attributable to fraud. (I.R.C. §§ 6651(f) (fraudulent failure to file) and 6663 (civil tax fraud)).

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Criminal Tax Evasion by the Decedent and the Executor – Defined and Basics

- Criminal Tax Evasion
  - Range of Crimes: The Code makes criminal at least 15 offenses for violating the internal revenue laws, the most basic of which is tax evasion.
  - Tax Evasion Defined: Tax evasion is defined as the willful attempt to evade or defeat any tax imposed by the Code.
  - Elements of Tax Evasion: To prove criminal tax evasion, the following must be proven *beyond a reasonable doubt*:
    - Willfulness;
    - Existence of a tax deficiency; and
    - An affirmative act constituting an evasion or attempted evasion of the tax
  - Consequences of a Criminal Tax Evasion Verdict: Criminal fraud results in punitive action with penalties consisting of fines and/or imprisonment.

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Avoidance Distinguished From Evasion

- Avoidance of taxes is not a criminal offense.
- Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. Gregory v. Helvering, 293 U.S. 465 (1935).
- The distinction between tax avoidance is fine, yet definite.

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Avoidance Distinguished From Evasion

- Tax Avoidance
  - One who avoids taxes by legitimate means does not conceal or misrepresent.
  - He or she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure.

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Avoidance Distinguished From Evasion

- Tax Evasion
  - Evasion involves some affirmative act to evade or defeat tax or payment of tax
  - Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are
  - Common evasion schemes include intentional understatement or omission of income, claiming fictitious or improper deductions, false allocation of income, improper claims, credits or exemptions, and/or concealment of assets.

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Avoidance Distinguished From Evasion

- Example
  - Tax Avoidance
    - The creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is legitimate tax avoidance.
  - Tax Evasion
    - If, however, an alleged partnership was not in fact established and one or more of the purported partners secretly returned his or her share of the profits to the real owner of the business, who did not report the income, this would be an instance of attempted evasion.

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Burden of Proof

- Civil Tax Fraud
  - Clear and Convincing Evidence: In civil cases the government must prove fraud with intent to evade taxes by "clear and convincing evidence." IRC § 7454(a); Tax Court Rule 142(b); Morse v. Comm'r, 419 F.3d 829, 832 (8th Cir. 2005).
- Criminal Tax Evasion
  - Beyond a Reasonable Doubt

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Proving Fraud

- The existence of fraudulent intent is a factual inquiry.
- Direct evidence of fraudulent intent is rarely available, and courts often determine the presence of fraudulent intent with circumstantial evidence.
- How to defend against allegation of fraud when the taxpayer is deceased?

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Badges of Fraud Courts Look to When Determining Fraudulent Intent

- Courts have developed factors, sometimes called *Spies* factors, in the civil context over the years to include the following:
  - Understating income;
  - Maintaining inadequate and/or misleading records;
  - Giving implausible or inconsistent explanations of behavior;
  - Concealing income or assets;
  - Failing to cooperate with tax authorities;
  - Engaging in illegal activities;
  - Providing incomplete or misleading information to a tax preparer;
  - Falsifying documents, including filing false income tax returns and making false entries;
  - Failing to file tax returns; and
  - Dealing in cash.
- No single factor is dispositive, but the existence of several factors may indicate fraud.

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Factors the IRS Examines to Determine the Existence of Fraud

- The IRS Fraud Program – Fraud Detection Begins During Audit by the RO Examining Badges of Fraud
- Among the badges of fraud the IRS examines are the following:
  - Affirmative acts of fraud taken by taxpayer, return preparer, and/or promoter to deceive or defraud (e.g., admitting on a wiretap that income was understated on returns);
  - Income indicators of fraud (e.g., unexplained increases in net worth, sizable personal expenditures, concealment of financial accounts, income omissions, bank deposits from unexplained sources, etc.);
  - Expenses or deductions indicators of fraud (e.g., substantial amounts of personal expenditures, overstatements of deductions, fictitious deductions, etc.);
  - Books and records indicators of fraud (e.g., maintaining multiple sets of books and records, false entries, failure to keep records, concealing records, discrepancies between books and tax returns, etc.);
  - Conduct of taxpayer indicators of fraud (e.g., false statements, failure to disclose, destroying books and records, transferring assets, backdating documents, false returns, etc.);
  - Method of concealment indicators of fraud (e.g., inadequacy of consideration, insolvency of transferor, related parties transactions, use of secret or offshore bank accounts, the use of nominees, etc.)

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What Makes a Civil Tax Fraud Case Turn Criminal?

"The attorney for the government should commence or recommend Federal prosecution if he/she believes that the person's conduct constitutes a Federal offense and that the admissible evidence will probably be sufficient to obtain and sustain a conviction, unless, in his/her judgment, prosecution should be declined because:

1. No substantial Federal interest would be served by prosecution;
2. The person is subject to effective prosecution in another jurisdiction; or
3. There exists an adequate non-criminal alternative to prosecution."

USAM 9-27.220 (updated Feb. 2018).

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What Makes a Civil Tax Fraud Case Turn Criminal?

- Commonly asked questions:
  - Can the Government prove willfulness?
    - <u>Willfulness Defined:</u> A voluntary, intentional violation of a known legal duty.
    - <u>Good Faith Misunderstanding May Negate Willfulness:</u> A good faith misunderstanding of the law or a good faith belief that one is not violating the law may negate the willfulness element.
  - Is there a reasonable probability of conviction?
  - Does the case have jury appeal (e.g., the presence of aggravating factors such as toys)?

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What Makes a False Return?

- A false return does not need to be signed to be treated as an affirmative act of evasion, as long as it is identified as the defendant's return.
- The fact that a return was signed by someone other than the defendant does not preclude a finding that the defendant knew of its falsity and had it filed in an attempt to evade.

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I.R.C. § 6064

- The fact that a return or other tax document is signed with the defendant's name is prima facie evidence that the defendant signed the document.
  - I.R.C. § 6064 does NOT create a rebuttable presumption that the defendant knew the contents of the document.
  - Knowledge may be inferred from the facts and circumstances and signature is prima facie evidence that the signor knows the contents of the return.

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Statute of Limitations

- I.R.C. § 6531(2) provides that the statutes of limitations for willfully attempting in any manner to evade or defeat any tax or the payment thereof is six years.
  - As a general rule, the statute of limitations begins to run from the latter of the due date of the return or the last affirmative act of evasion.
  - If the delinquent filing of a false return is the method of attempting to evade, the statue will being to run on the date the return is filed.

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The King's Debtors Dying, The King Shall First Be Paid

A PR of an estate without enough property to pay all claims of the estate must pay the federal tax claim before other claims. 31 U.S.C. § 3713.

PRs becomes personally liable for unpaid federal estate tax of the estate and/or unpaid federal income tax of the decedent. See U.S.C. § 3713(a), (b).

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Pay the King First or Be Held Liable

- If the PR pays other creditors before paying the government, the fiduciary may be held personally liable to the extent of the payments that he turned over to creditors other than the government. 31 U.S.C. §3713(b); *United States v. Coppola*, 85 F.3d 1015, 1020 (2d Cir. 1996).
- IRS issues a Notice of Liability and sues the fiduciary in the appropriate federal district court
- Statute of Limitations:
  - 1 year after the liability arises or the expiration of the period of collection (10 years plus statutory extensions)

Recent Section 3713 cases

Estate of Lee v. Commissioner, No. 21-2921 (3d Cir. Aug. 23, 2022).

In re Estate of Graham, No. C093868 (Cal. Ct. App. June 27, 2022).

United States v. Estate of Kelley, No. 3: 17-cv-965-BRM-DEA (D.N.Y. Oct. 22, 2020).

United States v. Marin, No. 18 CV 9307 (VB) (S.D.N.Y. Jan. 22, 2020).

Procedures to Protect a Fiduciary From Personal Liability

File the following forms with the Service:

- Form 56, Notice Concerning Fiduciary Relationship
- Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)
- Form 5495, Request for Discharge From Personal Responsibility Under Internal Revenue Code Section 2204 or 6905

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Form 56

- Notice Concerning Fiduciary Relationship
  - Advises the IRS of the PR's relationship to the estate
  - File this form twice.
    - When the PR is appointed to let the IRS know who the PR is and where to send all tax notices
    - When the PR completes her job and is discharged

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Form 4810

Determine whether the Decedent owed back taxes by filing a Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)

A cautious PR will wait for the IRS to respond to this assessment request prior to making any distributions to the estate's beneficiaries.

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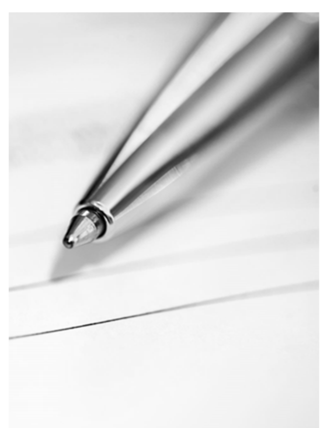
Form 4810 - Request for Prompt Assessment
IRM 25.6.1.9.6.1 (11-01-2004)

When we [the IRS] receive a written request for a prompt assessment, the tax must be assessed within 18 months after receipt of the request or 3 years after the original return was received, whichever is earlier (IRC 6501(d)). The request is generally made on Form 4810, Request for Prompt Assessment Under Internal Revenue Code 6501(d). The request must be:

- Made by a fiduciary representing the estate of a decedent and concern the liability of the decedent or his estate for income tax or gift tax (but not estate tax).
- Made by a fiduciary representing a dissolved corporation or one contemplating dissolution.



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Form 5495

File Form 5495, Request for Discharge of Personal Liability, separately but simultaneously as Form 4810

If Form 5495 is properly filed, the IRS has nine months to notify the PR of any deficiency for decedent's applicable income or gift tax returns

If the PR pays the additional tax or if no notice is received from the IRS within nine months from the date of filing Form 5495, then the PR is discharged from personal liability

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Form 5495

26 U.S. Code § 2204 – Discharge of fiduciary from personal liability

(a)General rule

- If the executor makes written application to the Secretary for determination of the amount of the tax and discharge from personal liability therefor, the Secretary (as soon as possible, and in any event within 9 months after the making of such application, or, if the application is made before the return is filed, then within 9 months after the return is filed, but not after the expiration of the period prescribed for the assessment of the tax in section 6501) shall notify the executor of the amount of the tax. The executor, on payment of the amount of which he is notified (other than any amount the time for payment of which is extended under sections 6161, 6163, or 6166), and on furnishing any bond which may be required for any amount for which the time for payment is extended, shall be discharged from personal liability for any deficiency in tax thereafter found to be due and shall be entitled to a receipt or writing showing such discharge.

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The Importance of Gift Tax Due Diligence

- IRC § 2204(d) provides:

If the executor in good faith relies on gift tax returns furnished under section 6103(e)(3) for determining the decedent's adjusted taxable gifts, the executor shall be discharged from personal liability with respect to any deficiency of the tax imposed by this chapter which is attributable to adjusted taxable gifts which—

(1) are made more than 3 years before the date of the decedent's death, and

(2) are not shown on such returns.

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Fraud by the Decedent

- Unreported domestic income
- Unreported foreign accounts
  - Streamlined program more likely in estate context
  - Traditional offshore voluntary disclosure program
  - Qualified amended returns
- Miscellaneous issues with foreign accounts
  - FBAR requirement applies to estates
  - Additional foreign reporting requirements may apply
  - Offshore penalties deductible

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Cases Involving Alleged Fraud of a Decedent

- *Fortunato v. Comm'r*, T.C. Memo.2010-105
  - The Tax Court held that an estate was not liable for a $11,662,737 estate tax deficiency or fraud penalty.
  - The IRS argued that the decedent owned an interest (and fraudulently failed to include in the decedent's gross estate) various warehouse companies.
  - Court found that the decedent did not own an interest in the warehouse companies, that there was no deficiency in estate tax, and accordingly, that the fraud penalty did not apply.

Cases Involving Fraud of the fiduciary

- *Estate of Trompeter v. Comm'r*, T.C. Memo. 1998-35, vacated and remanded, 279 F.3d 767 (9th Cir. 2002)
  - The Tax Court held an estate liable for a deficiency and fraud penalty
  - The Court relied upon the following facts:
    - The estate failed to report certain assets, undervalued other assets, and omitted and concealed the assets with the specific intent of evading tax;
    - The PR offered implausible and inconsistent explanations of her behavior, including that the decedent did not actually give the PR jewelry which she claims to have received as a gift before the decedent's death;
    - The PR failed to cooperate with the IRS by failing to disclose all of the decedent's records revealing purchases of jewelry, gems, art, and other artifacts; and
    - The PR was college-educated and had extensive work experience.

Questions?

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Thank You!

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