



"how will the IRS find out?" here's how

MSK Client Alert

January 19, 2012

by Jeffrey K. Eisen

"If I make a gift and don't report it on a gift tax return, how will the IRS ever find out?" is a common question asked by clients during the gift planning process. Other than the obvious answer that the law requires gifts in excess of the annual exclusion (\$13,000 per donee for gifts made in 2012) to be reported to the IRS, there often isn't a concrete answer as to how the IRS discovers unreported gifts made during life. (After a person's death, inquiries the IRS makes when it audits estate tax returns are designed to discover unreported gifts made during the decedent's lifetime.) However, pursuant to a recent federal court decision, California residents who made lifetime gifts or bargain sales of real estate to children or grandchildren may be in for an unwelcome surprise from Uncle Sam.

On December 15, 2011, the United States District Court for the Eastern District of California, in a decision that applies statewide, granted the request of the IRS to issue a "John Doe" summons on the California State Board of Equalization (BOE) to obtain the names of California residents who transferred real estate by gift, or for less than market value, to their children or grandchildren between 2005 and 2010. A "John Doe" summons is a legal demand by the Internal Revenue Service to a third party to provide information on unnamed, unknown taxpayers with potential tax liability, in this case, gift tax. In its request to the court, the IRS cited statistics from a survey it conducted which concluded that between 50% and 90% of individuals who gave real property to their children or grandchildren did not report the gift on gift tax returns. This was the key piece of information that led the court to grant the IRS request to issue a summons to the BOE to find out the names of California residents who may have made such unreported gifts.

In California, the BOE collects records from each of California's 58 counties regarding real property transfers, making the BOE the proper target for a summons (rather than forcing the IRS to issue summonses to all 58 individual counties), according to the court decision. Under California law, transfers of real property, even by gift, trigger a reassessment of the transferred property to market value for property tax purposes, pursuant to Proposition 13. However, transfers of a primary residence from a parent to a child are eligible for

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exemption from property tax reassessment to market value. That same exemption also applies to transfers of any other kind of real property from a parent to a child, as long as the total value of the property transferred has an assessed value (not a market value) of \$1,000,000 or less. Since property held for a long time can have an assessed value for property tax purposes of far less than its current market value, this allows parents to transfer real estate worth much more than \$1,000,000 to children without such property getting reassessed under Proposition 13. (A similar but much less common exemption is available for these same transfers from a grandparent to a grandchild, but only if the child of the grandparent who is the parent of the grandchild is deceased.)

To claim these exemptions, the transferring parent or grandparent must file certain forms with the County Assessor for the county in which the gifted property is located. While the court decision does not mention the specific information or documentation the IRS is going to seek under the summons, it is likely that the IRS will demand copies of these exemption claim forms. The IRS then could contact the donor/parent to ask why that parent did not file a gift tax return to report the fair market value of the transferred property in the year of the gift.

It is not clear why the IRS limited its inquiry to transfers made during the six-year period of 2005-2010, but one certainly can imagine that, if this John Doe summons bears fruit, the IRS will try to issue another such summons covering transfers in 2011, 2012, and future years.

Thus, unless the BOE successfully appeals this court decision to the Ninth Circuit Court of Appeals, an unknown number of Californians could be in for a very unwelcome and expensive letter from Uncle Sam. There is no statute of limitations for the IRS to initiate a gift tax audit if the taxpayer did not file a gift tax return for the year of a gift (or as to unreported gifts made in a year for which a gift tax return was filed to report other gifts). Moreover, in all of the years in question, the gift tax exemption was \$1,000,000 (as opposed to the current \$5,120,000), and gift tax rates ranged from 35% (the rate for gifts made in 2010) to between 41% and 47% for gifts made in 2005-2009. Interest would also be due on the unpaid tax (generally from April 15 of the year after the gift was made until the date the gift tax actually is paid). The IRS also may assert "failure to file" and "failure to pay" penalties, which can add another 25% to the total amount due.

Please contact any member of our Trusts & Estates practice group if you have any questions regarding this development.