I.R.S. Sees Increase In Evasion of Taxes On Gifts To Heirs

To save on taxes, Americans routinely understate the value of what they give their heirs, particularly stock in family-owned businesses and real estate, new data from the Internal Revenue Service shows. But the agency has almost no resources to stop the problem, and a recently passed law has only increased the chances of not getting caught.

More than 80 percent of the 1,651 tax returns reporting gifts of $1 million or more that were audited last year understated the value of the gift, the I.R.S. found. The average understatement was about $303,000, on which about $167,000 in additional gift taxes was due. This alone cost the government about $275 million last year.

Understatement also appears to be flagrant among the quarter-million Americans who each year make smaller gifts, I.R.S. records show. 0n the 650 of these returns that were audited, the average additional gift tax the I.R.S. recommended was $97,000. The I.R.S. would not estimate the total cost to the government of understated gifts.

But it is clear that a far greater percentage of Americans who owe gift taxes shortchange the government than do Americans paying income taxes and other levies. What is more, the sums involved in each case are much larger.

Taxes on gifts and estates, while intended to make the system fairer, breed tremendous resentment, and many Americans think they should be eliminated or sharply reduced. Last year, Congress voted to repeal the gift and estate tax. President Clinton vetoed the measure.

But as long as they are the law, people are obligated to pay them, said the I.R.S. Commissioner Charles O. Rossotti. People who do not, and whom the I.R.S. fails to force to pay, end up with a much better deal than their neighbors who are playing by the rules.

"Our system depends on voluntary compliance," Treasury Secretary Lawrence D. Summers said. "Individuals cannot decide for themselves if the rules apply."

The I.R.S., its auditing and legal staff shrinking in recent years even as the number of complex tax returns grows, lacks the resources to find most of the Americans who understate the value of their gifts and estates or even fail to report any transfer of property, said John Dalrymple, director of I.R.S. operations. The I.R.S. has just 78 lawyers assigned to gift tax audits, each of whom is responsible for auditing more than 3,300 gift tax returns this year. And even when the agency does find abuses, it lacks the resources to fight more than a small number of the cases in court.

I.R.S. lawyers said they were frustrated by their inability to stop what they described as rampant cheating on gift taxes.

One such lawyer in Manhattan, the nation's wealthiest tax district, said his desk was piled high with gift tax returns that will get little scrutiny. "There is all this added work and no staff," said the lawyer, who insisted he not be identified. "I know that there are millions and millions and millions of dollars being passed untaxed right over my desk and there is nothing I can do about it."

Of the more than 250,000 gifts of less than $600,000, only 1 in 400 is even audited, while among gifts of $600,000 to $1 million, fewer than 1 in 55 is audited. By contrast, the I.R.S. has been auditing 3 of every 4 gifts of more than $1 million, but says that this is inadequate and that it

is hiring 3 more lawyers so it can audit 85 percent of returns reporting very large gifts.

The agency's task has only become more difficult. For one thing, the number of gifts of $1 million and up jumped 21 percent last year from 1996, and the I.R.S. expects additional increases of at least 5 percent annually.

Resources are further strained by a sharp rise in estate tax returns, which are expected to grow by a third in the next four years.

Each year, nearly three times as many gift tax returns are filed as estate tax returns, although the estate tax raises six times as much money. But the gift tax, more than the estate tax, has recently increased the I.R.S.'s workload, because of a law passed by Congress in 1997 to require speedy audits of gift tax returns.

The Taxpayer Relief Act of 1997 gives the agency three years to audit gift tax returns -- or accept them as filed. Under the old law, such returns could be audited and challenged years or decades later, typically when the donor had died and his estate tax return was filed. The new law, and the widespread knowledge that the I.R.S. can hardly audit all gift tax returns, has encouraged some taxpayers to aggressively undervalue assets on the assumption that the I.R.S. either will not notice or will fail to act before the three-year audit period ends.

Data compiled by the I.R.S. shows how the problem has grown. In 1996, 1,816 gift tax returns with values of $1 million or more were filed. Last year, there were 2,194 such returns. The average amount of additional taxes owed because gifts were undervalued was $167,000 last year, up 45 percent from $115,000 in 1996.

These numbers show "we have a compliance problem," said Tom Hull, national director of specialty taxes for the I.R.S.

The amounts were calculated using rules set by Congress and the courts to measure the value of assets. The rules are based on factors like the cash flow of a business or its history of dividends or, in the case of real estate, sales of comparable properties.

In Cases of direct gifts of cash and publicly traded securities, there are few problems, Mr. Hull said. The understatements involve harder-to value assets, mostly family-owned businesses and real estate.

Gift and estate taxes, which are taxes on transfers of property during life and after death, respectivily, are the fastest-growing source of tax revenue for both the federal government and the states. This reflects the rise in the stock market and in real estate in the past decade, the aging of the World War II generation, which owns most of this wealth, and the decision by Congress not to adjust the gift and estate tax to take inflation and other factors into full account.

The I.R.S. collected $2.7 billion in gift takes in 1997, a figure that is expected to grow to $3.6 billion this year.

The gift tax works this way. For each gift to another person of more than $10,000 in a year, a gift tax return must be filed indicating the amount of the gift. When the total of such gifts exceeds $675,000 during the giver's lifetime, the gift tax kicks in. It must be paid on additional gifts greater than $10,000 per person each year.

The gift tax rates are the same as those levied on estates when people die, but the law creates powerful incentives to give before one dies.

Consider an individual with $1 million to give who is in the top tax bracket, which is 55 percent. When a gift is made while the giver is still alive, the heir gets $645,000 and the gift tax is $355,000. But if he gives away the money after death, the heir gets $450,000 and the estate tax will take $550,000. Thus, making the gift during the giver's lifetime puts $195,000 extra, or 43 percent more, in the heir's pocket.

But many Americans resent the tax and easily find ways to lower the amount they pay. "In my experience as an estate planner, it is very hard to get people to make taxable gifts," said Professor Edward J. McCaffery of the University of Southenr California Law School. "So when such gifts are made, we are by definition looking at extremely wealthy and extremely aggressive and dynastically inclined people, who are very sophisticated and who are going to shop around for a good appraiser and let him know they want to come in on the low side."

Professor McCaffery said, "There is a way of signaling to even the best of the appraisers whether you want a high value, which you want if you are selling your business or making a charitable gift, or if you want a low value because you are doing tax planning."

He said many wealthy business owners planning to make large gifts to their children "will first kind of muck up the business" by taking on debt or making other temporary changes to help an appraiser justlfy a figure much lower than the true value of the business.

Luther J. Avery, a San Francisco lawyer who often writes on flaws in the gtft and estate tax system, said: "There is a tremendous competition among appraisers, and each is trying to buy business from someone else, so they are low-balling their appraisals. Of course a client will choose the lowest appraisal."

Mr. Rossotti, the I.R.S. commissioner, said a rapidly growing industry is luring many prosperous Americans into illegal tax avoidance' schemes with promises of huge savings through methods like placing their homes in trusts or opening offshore investment accounts. These schemes are illegal if they lack a business purpose other than tax avoidance or if the income from offshore accounts is not fully reported. Americans are taxed on their worldwide income.

Shannon Pratt, widely regarded as the father of the business appraisal industry and the publisher of a newsletter read by many estate tax lawyers, said that in valuing businesses and real estate no one figure is correct. "There is a range of values" depending on how one interprets cash flow, competition and comparaple sales of real estate, he said. He said reputable appraisal firms come up with a fair range of values, but there are also disreputable firms producing unjustlfiably low appraisals.

The I.R.S. said its probiems are with appraisals, and with discounts applied to those appraisals, that fall outside a reasonable range. Discounts may be applied ior such factors as restrictions on the resale of stock in a family business or a minority interest in real estate.

But the I.R.S. does not have the staff to stop even many af the most outrageous cases.

Take the tax agency's Fresno, Calif., office, whose workload is typical of many I.R.S. offices. It received Il,OOO gift tax returns last year, and has three lawyers to audit them, Joseph D'Amico, a recently retired I.R.S, supervising estate lawyer, told a legal seminar in January.

Over all, such lawyers will spend 31 minutes auditing each tax return reporting a very large gift this year. Such returns typlcally run dozens of pages, with appraisals, descriptions of trusts and legal opinions.

One major area of cheating cannot even be detected under the current auditing system, two I.R.S. lawyers said. When a gift tax return indicates that total lifetime gifts have not reached the $675,000 threshold where taxing begins, the return is not audited. But both lawyers said that when they examined such returns at random, they found many cases in which gifts declared at a sum like $10,000 were really worth many times that.

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