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AUTHOR: Hodges, Charles E. II

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HANDLING AN IRS ESTATE OR GIFT TAX AUDIT AND BEYOND

Presented By

Charles E. Hodges II, Esq.

CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN

191 Peachtree Street, NE
Ninth Floor
Atlanta, Georgia 30303-1747
(404) 659-1410
(800) 800-0745

1400 Citicorp Center
1200 Smith Street
Houston, Texas 77002
(713) 658-1818
(800) 342-5829

CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN

A PARTNERSHIP OF PROFESSIONAL CORPORATIONS

ATTORNEYS AT LAW

191 PEACHTREE STREET, N.E. NINTH FLOOR

ATLANTA, GEORGIA 30303-1747

(404) 659-1410 (800) 800-0745

(FAX) (404) 659-1852

DIRECT DIAL NO. (404) 658-5439
E-MAIL: charles.hodges@chamberlainlaw.com

CHARLES E. HODGES II
SHAREHOLDER

HOUSTON
ATLANTA

CHARLES E. HODGES II, ESQ.

Charles E. Hodges II is a shareholder in the Tax Section of Chamberlain Hrdlicka's Atlanta Office, concentrating in civil and criminal federal tax controversies.

Mr. Hodges represents taxpayers against the IRS at all administrative and judicial levels from examination through court proceedings. Mr. Hodges has represented taxpayers in many different federal courts including: the United States Tax Court, the United States District Court for the Northern District of Georgia, the United States Court of Federal Claims, and the Court of Appeals for the Fifth and Eleventh Circuits. He is constantly involved in matters against the IRS and has yet to lose a trial against them. In all, he has been involved in cases in which taxpayers collected from the IRS over $1 million in attorneys' fees.

Mr. Hodges has been a key litigator in various cases earning him honors such as a "Leader in the Field" of Taxation by the *2005* and the *2006 Chambers USA—America's Leading Lawyers for Business* as well as a "Georgia Super Lawyers Rising Star" for 2005 and 2006. Some of his cases include:

Caracci v. Commissioner, -- F.3d --, 2006 WL 1892600 (5th Cir. 2006). The IRS sought over $250 million in excise taxes referred to as "intermediate sanctions" under I.R.C. § 4958 against three home-health care agencies and their owners in relation to the transfer of assets and liabilities when the agencies converted from tax-exempt to non-exempt status. The Federal Fifth Circuit Court of Appeals found taxpayers not liable for any excise tax liability. Complete taxpayer victory.

Estate of Lassiter v. Commissioner, T.C. Memo 2000-324. The IRS attempted to collect over $11 million from the estate of a prominent land owner in Georgia and New York by challenging a disclaimer executed by the family members involving a pre-1982 will. The Tax Court found the disclaimer to be valid. Complete taxpayer victory.

International Capital Holding Corp. and Subsidiaries v. Commissioner, T.C. Memo 2002-109. IRS challenged the deductibility of compensation paid between related companies under I.R.C. § 162. Court found company not liable for any additional income taxes. Complete taxpayer victory and IRS liable for attorneys' fees.

Trucks, Inc. v. United States, 1:96-CV-800 (No. Dist. Ga. 2002). In a jury trial in the Federal District Court for the Northern District of Georgia (Atlanta), the IRS attempted to collect millions from a large trucking company based on attack of their per diem plan for reimbursing drivers for over the road travel expenses. Court issued directed verdict to trucking company at the conclusion of the trial. IRS liable for attorneys' fees.

U.S. v. Jillson and Nixon, 99-2 U.S.T.C. ¶ 50,937 (DC-So. Fla. 1999). Rare taxpayer victory in summons enforcement case involving two executives of large installation company.

Full IRS concession of a $20 million civil fraud case docketed in the U.S. Tax Court against a large consolidated group based in the South.

Education
Clemson University (B.S., cum laude, 1992)
Mercer University (J.D. 1995)
University of Florida (LL.M., Taxation, 1996)

Affiliations
American Bar Association (Tax Section, and Real Property & Probate Section-Vice-Chair of Tax Litigation Committee)
Atlanta Bar and Georgia Bar Tax Section (Chair 2005-2006)
Atlanta Tax Forum
Lawyers Club of Atlanta

Publications
Mr. Hodges is a Columnist for the *Journal of Taxation* and has authored numerous tax articles for the *Journal of Taxation* and *Estate Planning* as well as has been cited in publications including the *Wall Street Journal's* Real Estate Journal.com, *Financial Advisor*, and *Atlanta Business Chronicle.*

Speaking Engagements
Mr. Hodges speaks regularly on tax issues and has given presentations for the American Institute on Taxation, the Georgia Society of CPAs, Chattanooga Tax

Practitioners, South Carolina Society of CPAs, Minnesota Society of CPAs, and Georgia continuing legal education seminars.

HANDLING AN IRS ESTATE OR GIFT TAX AUDIT AND BEYOND

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I. **INTRODUCTION.** Since adoption of the Tax Reform Act of 1986, the highest tax rate within the entire federal regime has been the transfer tax, namely the estate, gift and generation skipping transfer taxes. Indeed, these rates can exceed ninety percent when accumulated. No area of tax law is so ripe for dispute, nor subject to such dramatic swings between what the properly protected aggrieved family need pay and what the insatiable appetite of the Internal Revenue Service seeks.

After the death of a family member, the remaining members are particularly vulnerable to IRS audit inquiries. Your client's sanity must be protected beginning on the date of the decedent's death and including all necessary preparation for, and response to, the estate tax examination. Clients, and even some of the clients' advisors, are sometimes too cooperative and submissive with respect to the IRS during these sensitive times.

All estate tax and gift tax returns are personally reviewed by the IRS to determine if further examination is warranted -- a process referred to as "classification." In recent years, up to 25% of estate tax returns filed were audited. Only the exceptional gift tax return is selected. However, the Service has recently added questions to the gift tax return to assist them in determining which returns may be ripe for examination.

The goal of this presentation is to identify the ways in which you may assist your client in avoiding an estate or gift tax controversy, identify the areas which present the greatest opportunities and exposure, and present the strategy for handling an estate and/or gift tax examination.

II. AVOIDING AN ESTATE OR GIFT TAX CONTROVERSY.

A. *Planning Stages*. The best game plan to prepare for an IRS audit before the return is filed. Some issues are obviously going to be "hot" with the IRS, and other situations will involve transactions a practitioner knows are likely to be closely scrutinized. Documents should be prepared with a possible IRS audit in mind.

1. The most difficult part of estate planning is getting the client to actually agree to and initiate an estate plan. Numerous issues prevent a client from either starting or finalizing an estate plan.

Among the reasons are (i) dealing with death; (ii) dealing with family issues; (iii) dealing with the overused "I'm too busy"; and (iv) the 85-year old that states "I am going to need my $20 million." No matter what the excuse, the estate planning practitioner must constantly remind his or her client of the importance of starting and *properly executing* an estate plan.

2. Meeting with client. Do not shy away from describing recent IRS positions on FLPs, etc.

3. Follow up meetings semiannually.

B. *Return Preparation*. At the time the return is prepared - - regardless of whether you were involved with the planning - - take the same sober look at the obvious as well as latent issues in the case before formulating a reporting position.

C. *Implementation*. Once the estate plan is designed and wills, trusts, and family partnerships are executed, the next steps are to fund the trusts and family partnerships, and follow the terms of the trusts and partnerships. An estate plan can be meaningless without proper implementation.

III. **DIFFERENCE BETWEEN ESTATE TAX DISPUTES AND OTHER TAX DISPUTES.** Despite the increasing popularity of gift tax examinations, the remainder of this outline will concentrate on the estate tax audit. The estate tax audit is fundamentally different from the income tax audit.

A. *Evidentiary and Logistical Issues*. The first fundamental difference is that the taxpayer involved is deceased. The unavailability of the most essential person may create problems in locating assets and supporting records, both for the taxpayer and the Service. An IRS E & G Attorney recently, however, insisted that the first interview be attended by the decedent (true story).

An individual who was secretive about his financial affairs during life is not likely to leave a clear audit trail. Family members may inadvertently throw away records and, when the executor is not a family member, these problems are exacerbated by the executor's unfamiliarity with the taxpayer's affairs.

B. *Impact of State and Local Law*. The legal implications of statutory provisions and interpretations of legal documents result in the estate tax audit often being controlled by local law interpretations much more than in any other type of federal tax audit. The preparer of the estate tax return must depend on the taxpayer's attorney for an in-depth analysis of such issues.

C. *Statute of Limitations*. Strict time limits apply to the audit of an estate tax return. Generally, under I.R.C. § 6501(a), a deficiency must be assessed or a statutory notice of deficiency must be mailed to the taxpayer within 3 years of the filing of the estate tax return. Under I.R.C. § 6501(c)(4), the time prescribed for assessment or mailing of a notice of deficiency cannot be extended by agreement of the taxpayer and the IRS. The only exceptions to the general rule of section 6501(a) are provided for:

1. False or fraudulent return. Assessment may be made or a notice of deficiency mailed at any time. I.R.C. § 6501(c)(2).

2. Omission of item over 25% of gross estate. A six-year period applies in the case of an estate tax return that omits from the gross estate items includible in such gross estate representing more than 25% of the gross estate stated on the return. I.R.C. Section 6501(e)(2).

D. *Transferee Liability*. Generally, the IRS has one year beyond the normal three-year period of limitations to assert collection of tax from a transferee, which may come as a shock to many recipients who may have long ago spent their inheritance. § 6901. For estate and gift taxes, a lien against the transferred property applies until "the tax is paid, or becomes unenforceable by reason of lapse of time." I.R.C. Section 6324. *See O'Neal v. Commissioner*, 102 T.C. 666 (1993).

E. *Importance of Maintaining Control*. The preparation stage for the estate tax audit is of critical importance. The estate tax return is a "one-shot" situation and the possibility of negotiating tax issues that "turn around" in future taxable periods is generally unavailable, unlike many income tax issues.

IV. PROCESSING OF REQUESTS FOR DISCHARGE OF PROPERTY SUBJECT TO THE ESTATE TAX LIEN.

A. *An estate may request a discharge of an estate tax lien.* I.R.C. 6324 or 6324A. These requests are done on Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien. Generally, the IRS will agree to the discharge as long as the estate shows the Service's interests are protected and the discharge will not adversely affect the Government's ability to collect the tax. *See*, I.R.M. 4.25.1.4.4 (12-31-2002).

B. Requests for discharge of property, release of liens, or subordinations of recorded liens or unrecorded liens (I.R.C. Section 6324 and 6324A) will be processed by IRS Technical Support advisors. Estate and Gift Tax groups for the Service will be responsible for reviewing examination issues that may arise in the processing of the requests, such as assisting in the determination of the tax liability.

V. PROCESSING REQUESTS FOR PROMPT DETERMINATION OF ESTATE TAX AND DISCHARGE FROM PERSONAL LIABILITY.

The estate should always ask for and present an application for prompt determination of the estate tax return in order to discharge any personal liability for estate taxes. *See,* I.R.M. 4.25.1.4.5 (12-31-2002).

1. The receiving function will acknowledge all applications filed separately and forward it to the Examination function at the Cincinnati Service Center.

2. Examination will associate the application with the return file.

3. If the return has not been filed, suspense the application to await association with the return file prior to classification.

VI. EXTENSIONS OF TIME TO PAY ESTATE TAX.

A. *Estates often need to extend the time to pay estate taxes.* The extension application is Form 4768. *See* I.R.M. 4.25.2.1.2.

B. *Estates can appeal a denied extension request*. The Estate and Gift Tax Manager will forward the request for appeal to the person (usually a Technical Support Advisor) who denied the extension to prepare a rebuttal and forward the entire package to the local Appeals office for a hearing. Copies of this file will be maintained with the extension file in Technical Support.

C. Technical Support will be responsible for notifying the Cincinnati Service Center that the estate has filed an appeal so the account is frozen and bills are not sent during the hearing process. *See* I.R.M. 4.25.1.4.7 (07-31-2002)

VII. IRS MAY REVALUE ASSETS "IN-HOUSE.".

A. Field offices may use the IRS engineers for advice and assistance in the valuation of real estate, closely-held stock, and works of art.

B. On large valuation issues, the Service will use outside appraisers, but they generally do not before the Notice of Deficiency is issued. *See* I.R.M. 4.25.1.4.8 (12-31-2002)

VIII. I.R.C. 6166 INSTALLMENT AGREEMENTS.

A. The Service requires estates to furnish a surety bond as a prerequisite for granting the installment payment election. Instead of furnishing a surety bond, the estate may choose to elect the special lien provided for in I.R.C. § 6324A that requires the estate to have a lien placed on a specific property. This property must have a value equal to the total deferred tax plus four years of interest and must be expected to exist until the entire tax is paid.

B. The Service Center will send a letter to the estate notifying it that the election has been tentatively granted pending review by an Estate and Gift Tax Group and that the estate will be required to furnish a bond in accordance with I.R.C. § 6165, or elect the I.R.C. 6324A special lien. *See* I.R.M. 4.25.1.4.9 (07-31-2002).

IX. ATTACK BY THE IRS - KNOW YOUR ENEMY.

A crucial key to winning any estate or gift tax dispute with the IRS is knowing how it operates and the rules which govern IRS behavior.

A. *The Estate Tax Examiner*. The government's agent is an attorney. Because the agent is trained in the law, the agent is able to understand the legal implications of the estate tax return and related issues.

B. *Audit Cycle*. The Cincinnati Service Center will classify the returns and if selected for further review, will ship to the local IRS office. I.R.M. 4.25.1. Once selected, the examiner generally must complete the examination within 6 months of the end of the statute of limitations that cannot be extended (if estate tax returns). Estate tax managers are instructed to maintain a maximum operating cycle of 18 months measured from the date of filing to the date of completion and processing by Examination. Moreover, they are instructed to initiate the estate tax examination within 9 months of the return filing date. I.R.M. 4.25.1.1.4.

C. *The IRS Approach*. The IRS estate and gift tax attorney has been directed previously by his handbook to audit the estate and not the return:

> Look at the estate tax return as an integrated picture of the decedent, both before and at the time of death. Page through the return noting decedent's age, cause of death, occupation, financial interests, assets and the deductions claimed. Your job is not simply to inspect books and records to verify items reported in the return. An estate tax examiner must exercise a high degree of skill to determine if all assets are disclosed and the credibility of data submitted pertaining to valuation of assets. IRS Examination Technique Handbook for Estate Tax

Examiners, I.R.M. MT 4350-31, § 332(1) (December 16, 1987).

Thus, the essential question considered by the agent is: does the return reflect all items in the gross estate which would normally be expected taking into consideration the decedent's station in life, the known facts including his/her age, marital status, residence, occupation or profession, business interests, relationship to other wealthy taxpayers, and deductions claimed on the return?

1. The agent is urged to focus on a number of areas outside the estate tax return, including the following:

(a) Mortgages -- check collateral

(b) Insurance policies -- check property covered

(c) Special bequests -- check listed assets

(d) Letters prepared by the decedent directing the specific distribution of personal assets

(e) Assets normally associated with the type of business in which the taxpayer was involved -- e.g. farm equipment, etc.

(f) Assets displayed either on prior gift tax returns or on the depreciation schedules of income tax returns. Also, the estate and gift tax examiner is directed to check deductions which may arise from certain types of assets

(g) Scrutiny of state probate files

(h) Safe deposit box inventories

(i) Fractional interests as indications of prior transfers of interest

(j) Prior inheritances

2. Certain matters, deductions, and adjustments draw special attention by the IRS. The IRS E&G tax attorney is directed to be sensitive to certain types of things, including:

(a) Failure of a preparer to answer all questions on the estate tax return. The handbook indicates that an unanswered question is probably attributable to a preparer who is careless.

(b) Failure of a preparer to attach all required documents. A return that does not have attached to it the required documents is likely to be audited.

(c) Controversial or technical estate tax return issues apparent from the return such as: closely-held business assets, QTIP provisions, special use valuation, cash hoards, art items with a value in excess of $20,000, discounted notes, foreign assets, fractional interests, and assets in decedent's safe deposit box claimed to be assets of other family members.

(d) Any use of the word "discount."

(e) Claims against the estate by related parties. Often these claims may trigger an Information Report on the recipient to ensure reporting for income tax purposes.

(f) Disputed tax liabilities

(g) Internal inconsistencies on the return.

(h) Other contingent claims, causes of action, and the like.

X. **RELATED RETURNS.** Related returns play a major part in the estate tax examiner's audit of the estate tax return.

A. *Income*. The examining agent will often request and review the income tax returns of the decedent. The agent also reviews the income tax return for possible estate income items consisting of income in respect of a decedent. Whether an item of income constitutes income that should be reported on the decedent's final income tax return or constitutes income in respect of a decedent reportable on the estate income tax return is not always easily determined.

B. *Gift*. The examining agent is instructed to review the decedent's gift tax returns. Although all post-1976 gifts must be reported on the estate tax return Form 706, the Internal Revenue Service maintains all original copies of gift tax returns filed by the decedent and combines copies of such returns with the estate tax return prior to the estate audit. Prior to TRA of 1997 and Internal Revenue Restructuring and Reform Act of 1998, gifts could be revalued for estate tax purposes. However, under current law, the IRS is prohibited from revaluing inter vivos gifts for estate tax purposes after the statute of limitations for assessing the gift tax had expired, provided the donor satisfies the adequate disclosure requirements contained in the Code and Regulations.

C. *Generation-Skipping Exemption*. The examining agent will also consolidate the gift transfers and estate transfers for purposes of

determining application of the generation-skipping exemption under I.R.C. § 2631(a). The failure to make an affirmative allocation of the exemption amount for lifetime gifts and death transfers will result in automatic allocation under I.R.C. § 2632(b) and (c). The automatic allocation rules can create disastrous results in certain situations and can effectively reduce the substantial long-term benefit of the exemption amount.

XI. **<u>THE TAXPAYER'S COUNTERATTACK</u>.** It is absolutely critical that one attack these matters with vigor, sensitivity, and imagination - at the right time.

A. *Conduct the audit with litigation in mind*. Immediately after receiving notice of an audit, the advocate should begin developing his or her overall litigation strategy, because failing to prepare with an assumption that a trial will result will inevitably come back to haunt the taxpayer.

1. Identify all potential issues and then resist the temptation to demonstrate your prowess - and in the process, telegraph the existence of an issue that would otherwise go unnoticed.

2. Classify the issues based upon where they are best resolved; audit, Appeals, or trial. Almost never bank on judicial appeal.

3. Narrow the issues when possible and, by all means, rarely assume issues will necessarily be identified.

4. Keep alive trade-off issues once identified.

5. Resist the government's efforts to explore facts that are either adverse or relate to an issue on which either the Service or the particular E & G Attorney is predisposed.

6. Educate the E & G Attorney on the facts favorable to your case and assist him in writing his or her report (thereby laying the foundation for later obtaining an admission in either the Answer, Request for Admissions, or Stipulation). Beware, however, of today's favorable fact that could force a different issue tomorrow.

7. Preserve your opponent's error until the most advantageous moment for disclosure.

8. Avoid inadvertent or irresponsible admissions by you or your client.

9. Remain ever sensitive to the statute of limitations and other time pressures.

B. One of the major areas of emphasis in the examination of returns in recent years has been the Service's desire, and for a while their demand to interview the taxpayer.

1. The Service feels that the revenue agent has a better opportunity to find tax adjustments on returns if the IRS is not "shielded" from the taxpayer by the taxpayer's representative.

2. At one point, the IRS demanded that the taxpayer be present at the initial interview in essentially every case and answer questions asked by the agent.

3. Both the American Institute of Certified Public Accountants and the American Bar Association protested vehemently. Finally, as generally required by the Taxpayer's Bill of Rights, the IRS has agreed to interview anyone that has first hand knowledge and can answer the questions in an adequate manner which does not hinder the examination. Specifically, I.R.C. Sec.7521(c) states in relevant part:

> Representatives Holding Power Of Attorney. Any attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the Internal Revenue Service ... may be authorized ... to represent the taxpayer in any interview in any interview described in subsection (a).An officer or employee of the Internal Revenue Service may not require a taxpayer to accompany the representative in the absence of an administrative summons ...

XII. **<u>THE APPELLATE DIVISION</u>.** Long before ADR became the rage, the Appellate Division provided an effective alternative mechanism for resolution of tax disputes.

A. *Success Rate*. Its rate of success in resolving disputes still exceeds most forms of ADR.

1. The stated goal is an amicable resolution of at least 85% of the disputes it considers.

2. Most well-run Appeals Offices exceed a resolution rate of 90%.

B. *Incentive to Settle*. The settlements generally reflect all of the factors affecting the prospects for prevailing or, as Appeals phrases it, "hazards of litigation."

1. A well prepared or represented taxpayer is generally well rewarded.

2. The IRS faces few risks with a poorly prepared or represented taxpayer and the settlement position of the government will be tailored accordingly.

C. *Mirror Reality*. Studies of the government's success and failure rate in litigation confirms that this approach mirrors the reality: the government wins most cases but loses most dollars. The reason is that big cases are better prepared and presented by the taxpayer. The same is true in Appeals.

D. *Mission*. Appeals' mission is to settle cases:

> "The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." I.R.M., Administration.

1. Chiefs, Associate Chiefs and Team Chiefs are also empowered to enter into closing agreements where appropriate.

2. Few Appeals Officers are well trained in estate and gift tax cases. Those that are you will see case after case.

(a) Purpose. Appeals was intentionally created as a separate division from the Examination Division to ensure its independence and improve the possibilities of settlement.

(b) Authority to Settle. Appeals generally has initial authority to settle all issues without consultation with local District Counsel.

3. Appeals has sole jurisdiction in cases that have not yet been filed in the Tax Court, but Appeals Officers may request District Counsel attorneys to provide their view of the issues and the likely result of litigation.

(a) When the case is in the Tax Court, Appeals has complete settlement authority until the case is calendared, unless the case involves fraud penalties, but it is not uncommon for District Counsel attorneys to take part in settlement conferences before the case is actually calendared.

(b) A higher ranking IRS Counsel must approve any IRS concession of the civil fraud penalty where the taxpayer was previously referred for criminal prosecution.

E. *Appeals Jurisdiction*. Depending upon the type of dispute with the District, there are generally three avenues to Appeals: (i) protest of an Examination or Collection Division report; (ii) automatic referral to Appeals following the IRS filing an Answer in a Tax Court case which has not previously been through Appeals; or (iii) payment of a tax, filing a claim for refund, drawing a disallowance of the claim, and protesting the disallowance.

1. Protest in Response to 30-Day Letter.

2. Appeals has jurisdiction to consider a protest of an RAR, a protest of a proposed Responsible Person 100% penalty, and, more recently, a protest of the proposed denial of an Offer-In-Compromise.

3. Appeals will not accept a case with less than six months left on the statute of limitations. Therefore, Exam will not issue a 30-day letter if less than nine months is left on the statute.

4. Appeals will generally solicit a Form 872A to extend the statute indefinitely if the District has not already obtained a sufficient extension. Of course no extension can be granted in an estate tax case.

5. This avenue is the only pre-payment path to Appeals for most excise taxes and those actions by the Collection Division which are subject to protest. Additionally, protests are sometimes used for public figures who wish to avoid the prospect of any publicity, although a Tax Court petition or Claims Court complaint can typically be handled in a discrete manner. A District Court complaint for a public figure is more problematic.

6. If a settlement is not reached in a matter subject to the statutory deficiency procedure, Appeals will then issue the Notice of Deficiency (90 day letter) and generally the taxpayer will have the burden of proof with respect to the contents of this notice. Taxes which are not subject to the deficiency procedures will be assessed in the absence of a settlement.

F. *Petition to Tax Court.* Appeals has jurisdiction to consider settlement of any case which has been filed in Tax Court and not previously considered by Appeals. Generally, this involves income, estate, gift, windfall profit, and a few excise taxes; transferee and fiduciary liability; and exempt organization, pension plan, and disclosure declaratory actions.

1. Under special circumstances, Appeals will accept a request for a second consideration of a case that was previously considered by Appeals.

2. The filing of a timely Petition tolls the limitations period until 150 days after the Tax Court decision becomes final.

3. The Notice of Deficiency tolls the limitations prior for 150 days.

4. If the limitations period has less than nine months to go and the taxpayer refuses to extend the statute, Exam will issue a Notice of Deficiency.

G. *Protest of the Proposed Rejection of a Claim for Refund*.

1. After the tax is assessed and paid, the taxpayer has two years from payment or three years from when the return was due, whichever is later, to file a claim for refund.

2. If the IRS District proposes a disallowance of the claim, the proposed disallowance can and typically should be protested to Appeals. Problems arise when the District fails to take any action.

3. The statute of limitations upon assessment of additional taxes runs regardless of whether a claim has been filed.

H. *Appeals Personnel and the Politics of Settlements*.

1. Experience. Appeals Officers generally are experienced former revenue agents, revenue officers, or estate and gift tax attorneys.

2. Attitude. All Appeals Officers view themselves as fair and impartial. Most are fair, but the level of impartiality and independence varies widely.

3. Loyalty. All Appeals Officers are, however, paid by the IRS.

4. Stature. Most are receptive to the suggestion that their role is more in the nature of an administrative law judge.

5. Pressure to Uphold IRS Position. Recently, the IRS has discovered that Appeals has not been sustaining the Examination Division on many issues in large case audits and various targeted issues. Most private practitioners believe the reason is simple: Appeals has a superior grasp of the hazards of litigation than does the Examination Division.

XIII. NEVER SAY NO?

A. *Undermining Your Prospects through Conventional Audit Wisdom.* Problems arise when you never say no. Consider the negative consequences when you never say no to the following situations.

B. *Taxpayer Interview*. Never say no to a request or demand for an interview of the taxpayer and get your client butchered, have his honest failings in recollection perceived as deception, trapped into admissions or subtle characterizations, etc.

C. *Place of Audit*. Never say no to a request to conduct the audit at the taxpayer's place of business or, worse yet, his or her residence and supply your enemy with additional ammunition.

D. *Document Request ("IDR")*. Never say no to any request for documents and never put the government to its statutory obligations in obtaining damaging documents. After all, you cannot let your handling of this case today damage your relationship with this IRS group tomorrow – "you've got to live with these people" – unless of course you want to fulfill your ethical and fiduciary duties to today's client.

E. *Correcting the Agent's Errors*. Never say no to the temptation to point out to the agent how he was wrong about those facts, missed these authorities, and failed to consider the full implications of (and issues relating to) his proposed adjustments – unless you're interested in helping your client.

F. *Revealing Your Superior Knowledge*. Similarly, never say no to the overpowering compulsion to intimidate the agent with your superior knowledge of the facts and law. Otherwise, you will feel sheepish about billing the time it took to obtain that knowledge. Yes, this temptation is a surefire way to both motivate and educate your adversary.

G. *Extension of the Statute of Limitations*. Never say no to a request for waiver of the statute of limitations lest, according to the agent, you be denied your appeal rights and suffer all manner of penalties. In any event, it is generally cheaper to continue the audit than it is to start a whole new procedure - according to the conventional wisdom.

H. *Request for "Agreed" Case*. Never say no to a request for an "agreed" case except in those rare circumstances where the agent is clearly wrong.

I. *The Detailed Protest*. Never say no to the opportunity to file a detailed protest, overstate your case, and expose you and your client to mortification on cross-examination.

J. *IRS Expectation*. The IRS National Office takes the stated position that taxpayers should resolve their cases at the audit level but, if one wishes to go to Appeals, the IRS prefers the taxpayer to go to Appeals by way of protest rather than "through the back door" after filing a Tax Court Petition. Great idea if your client is the IRS.

K. *Details, Details, Details.* The IRS publication outlining "appeal rights" requests a detailed "statement of facts supporting your position in any contested factual issue," as well as a statement detailing the law upon which you rely.

L. *The "Accepted View" of the Protest.*

1. The "accepted view" is that the protest should always be a complete statement of the strongest arguments that support the taxpayer.

2. The "accepted view" is that since the taxpayer has the burden of persuasion, the taxpayer must meet the RAR head-on with a detailed protest.

3. The "accepted view" is that the protest is the most important part of the negotiation process and is crucial to an effective presentation of the taxpayer's position.

4. The "accepted view" is that failure to address squarely the issues raised in the RAR undercuts the taxpayer's position and reduces the persuasive force of the protest.

5. The "accepted view" is that taxpayers should set forth fully all the relevant facts so that the correct facts are on the table.

6. The "accepted view" is that all relevant legal authorities should be set forth and discussed in the protest.

M. *Negotiating with IRS is based upon Substantive Law*.

1. Argument. The "accepted view" is that the purpose of the appellate conference is merely to argue the questions raised by the RAR and the protest.

2. Treating the Appeals Officer as Judge. The "accepted view" is that since the protest is the key to the settlement, the focus should be on convincing the Appeals Officer that the protest is correct.

N. *The "Accepted View" Generally Undermines Your Case*.

O. *Get Real: The Real World of Negotiation.*

1. Audits are Complex. A civil tax case is similar to complex litigation.

2. Multiple Issues. There are numerous factual and legal issues.

3. Command of the Issues. Relative knowledge of the two sides will be determinative of the negotiation process.

4. Limited Resources. Resources rarely permit the agent to prepare the case as thoroughly as is required for an adversarial procedure.

5. Go to Appeals in Every Significant Case. Statistically your client has a better chance of saving more money by going to Appeals in a significant case than he does by working next year. Rare is the properly developed case for which no real "hazards of litigation" can be found.

6. Big Dollars. If the amount involved is significant, go to Appeals.

7. Big Issues. If the issues impact other years, taxpayers, and even types of taxes, go to Appeals.

8. Big Problems. If you have evidentiary, penalty, statute of limitations, equitable, or agent problems, go to Appeals.

9. Appeals Procedure Can Favor the Taxpayer. The IRS has devised an appellate procedure that can be most advantageous to the taxpayer, although there are signs that the District is applying increasing counter-pressure.

10. Revenue Agents. While Revenue Agents have an expansive view of the world and are therefore the most dangerous individuals in the IRS, time and resources restrict them. They are not trained fact-gatherers, they are not trained writers, and, absent some provocation, their research is often limited.

11. Appeals Officers. The IRS negotiator is new to the case: can you imagine assigning a new attorney to negotiate a settlement in a three-year old case?

(a) The IRS negotiator, in contrast to the Revenue Agent, has a contracting view of the world: his or her success is measured by getting rid of issues and cases - not expanding them.

(b) The IRS negotiator is often not a trial lawyer or a trained tax lawyer. He or she is, however, exposed on a daily basis to sophisticated financial transactions and tax controversies. Consequently, the Appeals Officer will have an understanding of the accounting side that is superior to most lawyers and an understanding of the overall procedure that is superior to most accountants. Nonetheless, the

Appeals Officer often cannot compete well on an overall basis with a well prepared taxpayer team.

(c) The IRS negotiator is not a fact-gatherer and is told not to raise new issues that are not significant or material.

(d) The IRS negotiator does not have the power or the inclination to take depositions or issue summonses.

12. The IRS negotiator will, like us all, see all issues through the prism of his or her personal history, experiences, and value system but the Appeals value system is not necessarily dollar-driven.

(a) The IRS negotiator is under time pressure, at least in docketed cases.

(b) The primary disadvantage is that the Appeals Officer will lack independence or the facility for compromise. The incidence of these problems is higher in, though not unique to, new Appeals Officers.

P. *Protest.* A detailed protest may do a better job of raising the significance of damaging issues and facts than did the RAR.

1. A protest that joins the issue without setting forth an extensive explanation of the taxpayer's position may leave the taxpayer the flexibility to develop the most persuasive argument for the particular Appeals Officer.

2. A more skeletal protest will not raise new issues or educate the Appeals Officer.

3. Because many tax practitioners follow the admonition in the IRS publication requiring the taxpayer to swear under penalties of perjury to the accuracy of the facts in the protest, those facts can often be used against the taxpayer as admissions-against-interest on unanticipated IRS arguments or as a basis for simple impeachment ("You swore under oath in your protest that you were breeding 37 thoroughbreds on this so-called profit motivated farm when in fact you only had seven ponies, six burros, and a goat with whom you had an unnatural relationship - isn't that true Mr. Greenjeans?").

4. New issues raised by Appeals[1] in a protest case will be included in the Notice of Deficiency (thereby, subjecting the taxpayer to the

1 Appeals have a stated policy against raising new issues, except in unusual circumstances. Consequently, these new issues may be characterized as new theories in support of the deficiency. Additionally, exceptions are being drawn with increasing frequency.

burden of proof) or held over his head during settlement discussions like the sword of Damacles.

Q. *Tax Court Petition*. Never file a protest on a significant matter that can be taken to Appeals through the Tax Court - unless you have an overpowering reason. Advantage of approaching Appeals through the Tax Court include:

1. Generally more powerful for negotiation purposes because the Tax Court petition is itself a symbolic embodiment of "hazards of litigation" – the phrase most commonly used by Appeals to justify settlements.

2. The presence of a Tax Court petition focuses the parties upon the disparity between the parties in external exposure (:If I lose this case, then I lose it; but if you lose it, you lose this one and a thousand just like it").

3. Substantially reduced chance of IRS raising new issues.

4. IRS has the burden of proof on any new issues raised.

5. Petition provides the taxpayers with the opportunity to "shift the battle to more favorable ground" by raising new procedural and substantive issues without being threatened with an exile back to the District.

6. Since the IRS is accustomed to taking money and not giving it back, these new issues may raise the specter of a refund which -no matter how small - will have a disproportionate impact on the settlement discussions.

7. While a claim for reimbursement of administration and litigation costs is sometimes more saber rattling than rewarding, those claims only apply to costs incurred after issuance of the notice of deficiency.

8. In all events, these new issues will shift the pendulum of the negotiation balance.

9. If you chose the alternative route of going to Appeals before filing a petition in Tax Court and fail to settle, two bad things can happen: first, new or revised issues raised by Appeals will be dropped into the notice of deficiency and you will bear the burden of proof on a matter that otherwise would either not be raised or would be the burden of the IRS; and secondly, after the IRS District Counsel files the Answer in the case, he does not send the

case to Appeals - he holds it and engages in discovery that would likely never occur if the files were sitting in Appeals.

10. The traditional excuses for not filing a Tax Court petition (or a complaint in District Court) do not withstand analysis:

(a) "My client doesn't want the notoriety" - There is no real notoriety: the petitions are filed in Washington and can be as elliptical as you wish.

(b) "It's more expensive" - Tax Court petitions are typically less involved than protests, though the argument before Appeals is typically more involved. If the argument is properly orchestrated, those costs should be exceeded many times over by the savings in taxes, penalties, and interest. It is important, however, to keep in mind a risk/reward ratio regardless of how you approach Appeals.

(c) "I am an accountant and I will lose my case" - Not if it is properly handled: Tax Court cases are generally won or lost based upon detailed, accounting-driven defenses. You may, however, be converted from a representative into an expert witness, paraded into Appeals with a fanfare of trumpets, and forced to speak in professorial tones.

(d) "Filing a petition in Tax Court will delay the case" - On the contrary, court orders will expedite the handling of the case by Appeals and will provide a deadline not otherwise available.

(e) Always use the FOIA procedure and use it before filing the Tax Court petition.

R. *Initial Conference*. At the initial Appellate Conference, the Appeals Officer will generally set forth his understanding of the IRS's position. How do you get the Appeals Officer to educate you without psychologically committing himself or herself to some extreme?

1. Fully 50% of the time, you will be surprised by the Appeals Officer's perception of the issues. The Appeals Officer will give you issues without a fight you believed were difficult and the Appeals Officer will perceive IRS strengths you didn't anticipate.

2. You only have to deal with the problem as the Appeals Officer sees it, not as you understand it.

3. Your case may be simpler than you think: the Appeals Officer may not have much faith in the issue raised by Exam or he may

believe that the case is weak because Exam did not develop the facts.

4. At the first conference you can establish rapport with the Appeals Officer and learn his or her value system. How do you learn the Appeals Officer's value system?

5. Start by talking about any non-controversial topic except the case. Then professor and later U.S. Senator S.I. Hayakawa observed that new acquaintances or old acquaintances dealing with controversial topics have a psychological need to first establish a non-controversial common ground. That is why most conversations start with inane topics such as sports, weather, etc.

6. Move to common problems such as administrative difficulties and the like (i.e., comrades under a common tyranny).

7. Weave in the client's first name and then personalize the client. It is harder to hurt someone with whom you are on a first name basis. Never refer to a taxpayer as the "Taxpayer" or "Corporation": refer to the client as Bob, Michael, Susan, the company, the business, etc.

8. Ease into the vague description of the strengths of your case.

9. Solicit an open ended confirmation in hopes of deriving acknowledgements of other taxpayer strengths perceived by the Appeals Officer.

10. Solicit the perception of the Appeals Officer's perceptions of the District's weaknesses. Never, ever, ever polarize the Appeals Officer by stating your objections in terms of the "IRS"; isolate and detach those objections by referring to the culprit as "the District" or "the agent."

11. Validate his or her perception of those weaknesses and expand them into the areas which you have identified by the process of elimination as the areas the Appeals Officer perceives as the government's strengths.

12. In a courteous tone, obliterate those areas. Only get confrontational as an absolute last resort.

13. Ask what the Appeals Officer would reasonably expect that you might be able to get in the way of statements or evidence that would "make him comfortable with [your] position" and then negotiate him down from what is likely to be an unrealistically high standard to one you know you can meet.

14. Close the first conference by promising to do your best to get the Appeals Officer what you can.

15. As an aside, you are not obligated to correct an Appeals Officer's misunderstanding of the facts or the law though you must be careful never to misrepresent the facts or the law to any representative of the IRS.

16. A detailed protest can inadvertently telegraph omissions or errors by the agent which can be easily corrected by the IRS (especially in deficiency procedure cases) and thereby, strengthen the government's case.

17. It is virtually impossible for the Appeals Officer to avoid getting something wrong.

18. Remember that we are all subject to this human frailty.

19. It is always possible to provide detailed briefs after you have met the Appeals Officer and learned what he or she knows and how the Appeals Officer judges the arguments. Make sure your scholarship, factual description, and written presentation are superb because they will send a subliminal message about the hazards of litigation.

20. There is no limit to the number of conferences that may be held.

21. There are some high risk settlement strategies that generally should only be used rarely and with discretion:

(a) "Ogg & Grogg."

(b) "Cheat the Hangman."

(c) "Misconduct/IRS mortification."

(d) "Bury them."

(e) "Frontal assault."

(f) "Chinese Water Torture."

S. *Persuading the Appeals Officer*. After you have learned all that you can at the first conference, you have to decide how to finish moving the Appeals Officer toward your side of the issue and close the agreement.

1. Solve the Appeals Officer’s problems, not your problems.

2. Draft your arguments toward what the Appeals Officer understands about the issue.

3. What arguments will be persuasive?

4. Based upon facts?

5. Based upon cases?

6. Based upon economics?

7. Based upon fairness?

8. Based upon technicalities?

9. Based upon common sense?

10. Based upon exposure?

11. Make the Appeals Officer feel as good as he or she can about your side of the issue and about the value to the government of "getting rid" of this case.

12. Do not hesitate to draw the Appeals Officer into your discussion but do not let the Appeals Officer enunciate a number.

13. You are trying to persuade; the person must be considering your position to be persuaded.

14. Make sure that you know how the Appeals Officer is reacting.

(a) "Do you agree that . . . ?"

(b) "Isn't this more proof than you ordinarily get?"

15. You must, to the extent possible, allay his or her doubts.

16. You must be creative and responsive to the Appeals Officer's reaction.

17. You must make it memorable and entertaining if you can because you are selling the Appeals Officer on your ability to sell the judge.

18. Remember, Appeals wants to settle. The only issue is, how low can you go?

T. *Formulating the Settlement.* Settlement offers should be creative and designed for the particular Appeals Officer.

1. The Appeals settlement policy is to give serious consideration to an offer to settle a tax controversy on a basis that fairly reflects the relative merits of the opposing views in light of the hazards which would exist if the case were litigated. However, no settlement will theoretically be made based upon "nuisance value" of the case to either party. Nuisance value is generally considered to be 15%, but one should be careful in raising the subject of nuisance value lest it endanger, say a 4% settlement.

2. Settlements may be as creative as the mind of the taxpayer's representative.

3. Issues may be split.

4. Some issues can be handled prospectively or spread over a period of years.

5. Individual issues may be partially conceded based upon percentages.

6. Issues may be conceded for some years and not for other years.

7. Bottom-line dollar amounts may be agreed to.

8. Any settlement that fits within the range of what the Appeals Officer feels is "about right" can be worked out.

9. Issues that are important to the Appeals Officer may involve less tax cost, but may be bargained against more valuable issues.

10. The ability to persuade another human being that a particular settlement makes sense requires experience, sensitivity, flexibility, and knowledge. Persuasion is rarely achieved by written brief unless you first know the person for whom you are writing and what he or she knows. Mastery of the tax law, while certainly important, is a small part of the process. Detailed protests are the main weapon of people who are afraid to negotiate in person.

11. A detailed protest is probably valuable when the taxpayer is correct on the issue and the government should concede the issue. In such cases, destroying the RAR and treating each issue in detail may serve to facilitate full concession by the Appeals Officer.

(a) The danger is that you must be correct as a matter of fact and law or you will supply the Appeals Officer with the ammunition to argue against you.

(b) After you meet with the Appeals Officer, you can always supply a detailed brief.

(c) Additionally, it is sometimes helpful to draw the case into the refined intellectual realm of scholarship and away from the pack.

U. *The Closing*. Remember, the Appeals Officer has a range of what is the right settlement.

1. Try to persuade the Appeals Officer that the range is more in your favor by responding to his or her concerns.

2. You cannot get total concessions all the time; what would be a good result in this case?

3. Try to get the Appeals Officer to agree, in words, not numbers or percentages, where the settlement belongs.

(a) Taxpayer has a very strong case.

(b) The government should not want to litigate this issue.

4. When you have agreed in words, translate the words into numbers or percentages and push the settlement toward your end of the range.

(a) Do not get greedy; what is the range that will be acceptable and justifiable to the Appeals Officer's supervisor?

(b) Remember that the recalculation must be "sold" to everyone up the line of review at the IRS. Frequently, the IRS team will recalculate the results before a settlement proposal is tentatively agreed.

(c) Remember that there may be other cases; it is better to have a reputation of always being reasonable, then the Appeals Officer will think that the offer is reasonable because you made it.

V. *Post-Closing*. The Team Chief Appeals Officer has to justify his settlement with his or her Associate Chief and reviewer.

1. The Appeals Officer's job security and sense of well-being depends upon impressing his or her boss.

2. If the Appeals Officer fears that he or she cannot justify the deal, he or she will have trouble agreeing.

3. Ask the Appeals Officer what is needed in the way of support.

(a) Get the affidavit or the brief.

(b) Be timely -- now you are making the Appeals Officer look good.

(c) Can you give the Appeals Officer the write-up on a computer disc?

4. At this point in the process the Appeals Officer will not be reading skeptically.

XIV. THE "ART" OF NEGOTIATION.

A. *Definition of Negotiation*. Negotiation is the "art" of persuading another human being to act the way that you want that person to act. It is largely a matter of identifying the needs of that person and reconciling those needs with the needs of your client.

B. *Factors that Affect All Negotiations*.

1. The Person. What makes this person tick? What is the person interested in? What drives the person? What arguments or factors are particularly persuasive to this person? What are this person's needs? How does this person measure success?

2. Knowledge is Power. In all negotiations, the person with the greater knowledge has the advantage.

3. What do you know about the Appeals Officer?

4. Do you know what the Appeals Officer knows?

5. Does the Appeals Officer know what you know about the returns for the years in question? What about other returns, other years, and other affected taxpayers?

6. Does the Appeals Officer understand the issues? What does the Appeals Officer think the issues are?

7. In your case better prepared and better presented than the agents?

C. *Time*. The party who is under time pressure is at a disadvantage.

1. Appeals believe that most cases can be settled within six months of receipt.

2. Coordinated exams will take longer, but the IRS monitors the time taken to settle.

3. In protest cases, time is generally on the side of the IRS; in docketed Tax Court cases, time is generally on the side of the taxpayer.

D. *External Exposure*. The party with an external exposure - that is, an exposure beyond the amounts or issues currently in question - is subject to a disproportionate disadvantage.

1. Examples of external taxpayer exposure would include fraud liability, new negative issues, increased deficiencies, and the like.

2. Examples of external IRS exposure would include claims for administrative and litigation costs, new affirmative issues, unexpected refunds, and the like.

E. *Perceived Balance of Strengths and Weaknesses*. Most negotiations ultimately turn not on the actual balance of strengths and weaknesses for that balance cannot be known with precision: they ultimately turn upon the perceived balance.

1. That perceived balance is impacted by every conceivable factor in the case - substantive and procedural, personal and impersonal, stated and unstated.

2. In every case, that perceived balance will ride a roller coaster of ups and downs - settle on the ascension, delay on the decline.

XV. CASE STUDY.

A. *Estate of Lassiter*. The specific example for the general approach to a federal estate tax dispute is *Estate of Lassiter v. Commissioner*, T.C. Memo 2000-324.

B. *Facts*. Mr. Lassiter was a domiciliary of Clayton County, Georgia when he was killed in an automobile accident while in Singapore on May 9, 1994. He was 48 years of age. Henry was survived by his wife, Paula Ann Masters Lassiter and four daughters, Cathy, Cindy, Christy and Cheryl. The only will that could be found was a 1970 will – a will that was drafted when the multimillionaire Henry had practically nothing. Henry's 1970 will provide this estate would be divided into two trusts. The first trust was a marital trust giving Mrs. Lassiter income for life and principal distributions for her proper support and comfort. The marital trust was to be funded with one-half of Henry's Estate. This was the maximum marital deduction allowed at the time the will was executed.

The second trust (residuary trust) was funded with the remainder of the Estate. The income and principal of the residuary trust were to be used for the support in reasonable comfort of Mrs. Lassiter, the support and education of the children, and any descendants of a deceased child. Mrs. Lassiter had a special power of appointment over the residuary trust to appoint any portion of the trust property to her descendants. On her death, the remaining trust property was to be distributed as she directs in her will, or on failure of exercise, the trust residue was to be divided into shares for each living child and one share for the living issue of any deceased child.

The Estate and its attorneys were faced with a potential estate tax of over $14 million. The Estate decided to try to execute disclaimers by the residuary trust beneficiaries and the trustee in order to allow the residuary trust to qualify as a QTIP (qualified terminable interest property) trust.

On February 6, 1995, Mrs. Lassiter petitioned the Clayton County Probate Court requesting to be appointed trustee of the two trusts, and was given the power to disclaim trust powers. A guardian ad litem was appointed for Cheryl, a minor, and all unborn and unascertained beneficiaries of the residuary trust. On the same day, eight disclaimers were filed with the probate court, six by the three adult Lassiter children, Cathy's husband, the guardian ad litem on behalf of Cheryl and the guardian on behalf of any unborn and unascertained descendants. The disclaimers are substantially the same and renounced the disclaimant's interest in the residuary trust during Mrs. Lassiter's life. Mrs. Lassiter also executed two disclaimers, disclaiming her ability to appoint trust corpus out during her life and disclaiming the trustee's power to distribute income and corpus to the descendants.

On August 8, 1995, an estate tax return was filed, and the estate took a QTIP marital deduction under I.R.C. § 2056(b)(7) for the two trusts. The IRS issued a deficiency notice disallowing the marital deduction, alleging that Mrs. Lassiter did not have a qualifying income interest for life in the residuary trust as the disclaimers could not alter some of the terms of the trust including the fact the trust was not required to distribute all income.

However, the IRS allowed a marital deduction for one-half of the adjusted gross estate, and the parties stipulated that the marital trust qualifies for the marital deduction. Mrs. Lassiter petitioned for a redetermination of the marital deduction disallowance.

C. *Tax Court Opinion.* As the Estate consistently alleged a subsequent will existed, but could not be found, the IRS argued that the subsequent new will revoked the 1970 will. The problem was the subsequent will could not be located. Thus, the Tax Court determined that the 1970 will was not revoked by Georgia law, noting that it could not be an implied revocation, because the subsequent will, either lost or destroyed "without a trace," never became effective. Thus, any inconsistent provisions in that "will" were not effective to revoke under state law because there is no evidence that the will, with an express revocation, ever existed.

The Tax Court next determined whether the estate was entitled to a QTIP marital deduction for the amount passing to the residuary trust after the disclaimers. The court determined that the six disclaimers of the children and the guardian ad litem were valid to cut off the trustee's discretionary power to distribute money for their support and education. Thus, Mrs. Lassiter is the only beneficiary eligible to receive income and principal payments from the trust during her life. The court noted, also, that because the descendants disclaimed their right to "all" income earned by the trust during her lifetime, they have no interest in the income either now or after her death. Thus, Mrs. Lassiter, or her estate, are the only possible beneficiaries of the income, and the trustee has no meaningful discretion to accumulate income. The Tax Court held that the residuary trust, after the disclaimers, gave Mrs. Lassiter a qualifying income interest for life and no one had the power to appoint any of the trust property to anyone other than Mrs. Lassiter during her life.

XVI. THE NEW FEDERALLY AUTHORIZED TAX PRACTITIONER PRIVILEGE.

A. *Prior Law*. No Federal Privilege for Non-Attorneys.

B. *No Accountant-Client Privilege*. In Couch v. United States, 409 U.S. 322 (1973), the Supreme Court rejected the proposition that an accountant-client privilege shielded a CPA's tax return work papers from an IRS summons, saying that federal law recognizes no such privilege.

C. *Work Papers Also Not Protected*. Thus, the IRS may inspect an independent auditor's confidential tax-accrual work papers. An independent auditor plays a quasi-public role, rather than an advocacy rule, that is at variance with absolute confidentiality. United States v. Arthur Young & Co., 465 U.S. 805 (1984). (Before the Supreme Court rendered its opinion, the IRS revised the Internal Revenue Manual to

provide that tax-accrual work papers could be summoned only in unusual circumstances and only after the revenue agent had failed to obtain the requested information from the taxpayer. Internal Revenue Manual 4024.4. The Supreme Court was aware of the change. 465 U.S. at 821, n.17.

1. United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), was decided two years prior to Arthur Young. El Paso argued that because in-house counsel performed the tax-return review along with the help of the company's in-house accounting staff, the resulting work papers were privileged. The Government countered that the work papers embodied financial and business guidance, not tax advice. The Fifth Circuit held that whatever privilege may have existed was waived when El Paso shared the contents of the work papers with its independent auditors, but in dictum said that "[t]he line between accounting work and legal work in the giving of tax advice is extremely difficult to draw," and said it "would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice." 682 F.2d at 539.

2. United States v. Rockwell Int'l, Inc., 897 F.2d 1255 (3rd Cir. 1990). The IRS demanded Rockwell's in-house tax-accrual work papers, contained in a reserve file maintained by a Rockwell staff attorney. While rejecting the district court's position that such work papers were unprivileged, the court of appeals remanded the case for findings on four issues: Did the contents of the file constitute legal advice? Who prepared the work papers? Who controlled the file? Were the contents of the file disclosed to any third parties? The case was resolved by agreement on remand, so there is no subsequent opinion.

3. In United States v. Hankins, 631 F.2d 360 (5th Cir. 1980), the Fifth Circuit reversed criminal and civil contempt citations against an attorney who refused to answer questions concerning his review of the taxpayer's books and records in connection with an IRS criminal investigation of the taxpayer. The nature of the service being rendered -- to identify and quantify the extent of the client's potential exposure during the adjudicative or administrative phase of a tax controversy -- is privileged.

D. *Code Section 7525*.

1. Protection of Certain Communications. Section 7525(a)(1) extends the same common law protection of confidentiality to a communication between a taxpayer and any "federally authorized

tax practitioner" that would have been privileged if it were a communication between a taxpayer and an attorney.

2. Matters Covered. The new privilege may be asserted only in:

(a) Non-criminal tax matters before the Internal Revenue Service; and

(b) Any non-criminal tax proceeding in federal court brought by or against the United States.

E. *Definitions*.

1. Federally Authorized Tax Practitioner. The term "federally authorized tax practitioner" means any individual who is authorized to practice before the IRS if such practice is subject to federal regulation under 31 U.S.C. § 330. In other words, the phrase includes CPAs, enrolled agents, and enrolled actuaries.

2. Tax Advice. The term "tax advice" means any advice given within the scope of the individual's authority to practice before the IRS. In other words, it includes tax advice and tax representation.

3. Exception for Tax Shelters. The privilege does not apply to written communications between tax practitioners and directors, shareholders, officers, employees, agents, or representatives of a corporation in connection with the promotion of the direct or indirect participation in any corporate tax shelter as defined in Section 6662(d)(2)(C)(iii).

4. Effective Date. The privilege may be asserted only as to communications made on or after July 22, 1998.

5. Obvious Limitations of Section 7525.

6. Uncovered Return Preparers. By its terms, new Section 7525 is applicable only to communications between a taxpayer and a "federally authorized tax practitioner." This phrase includes CPAs, enrolled agents, and enrolled actuaries. Other accountants, bookkeepers, and possibly agents of otherwise qualified federally authorized tax practitioners do not appear to be included.

7. State, Local & Foreign Tax Matters. The phrase "tax advice" is defined with reference to practice before the Internal Revenue Service or in a proceeding before a federal court.

8. Query. Are state and foreign tax matters automatically excluded by this definition?

(a) The new provisions apparently do not cover state court foreclosure actions where one issue might be the priority of the federal tax lien.

9. Scope. The extension of privilege to "any non-criminal tax proceeding in Federal Court brought by or against the United States" in Section 7525(a)(2)(B) was inserted by the Senate (or the conference committee) and was designed to be broader than the House version, which had only covered tax litigation.

10. Non-Criminal. The statute is specifically inapplicable in criminal proceedings before the Internal Revenue Service and in criminal proceedings in a Federal Court. NOTE THAT TODAY'S PRIVILEGED COMMUNICATION LOSES ITS SECTION 7525 PRIVILEGE BY THE IRS COMMENCING A CRIMINAL INVESTIGATION TOMORROW.

(a) Bankruptcy Covered? Bankruptcy is not a non-criminal federal court matter "by or against the United States" until an adversary proceeding is filed.

(b) All Bankruptcy Covered? Does the new provision cover all bankruptcy cases in which the United States is a party, or just cases in which a determination of tax liability is involved?

11. Tax Shelters. The statute carves out written communications between practitioners and representatives of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter.

12. Ambiguous At Best. Although reference is made to Section 6662, the definition of tax shelter in that section is far from precise. See discussion below regarding unresolved issues.

13. Legal Advice Still Privileged as to Shelters. The tax shelter exception originally was designed to remove privilege from attorneys who advised regarding tax shelters as well. In the conference committee bill, lawyers were carved out of the exception. Senate judiciary committee chair Orrin Hatch and House judiciary committee chair Henry Hyde pressured the conference committee to drop all references to the attorney-client privilege in the corporate tax shelter exception.

14. Tax Return Preparation Not Covered. The privilege for tax advice is the same as if the professional were an attorney. This means, among other things, that the privilege does not ordinarily attach to the preparation of tax returns or to other areas where a

communication would not be privileged even if made to an attorney.

XVII. <u>THE KOVEL ACCOUNTANT: SOLUTION</u>? Because of the narrow limits of the new tax practitioner privilege, the attorney, not the taxpayer, should consider engaging the accountant in order to make certain that the accountant's work product will remain confidential. Moreover, if the tax case becomes a criminal matter or if non-IRS matters arise, the communications will not remain privileged unless the attorney has hired the accountant.

A. *The Kovel Case*. Communications made to an accountant who is assisting an attorney in providing legal service (not accounting service) to a client are within the attorney-client privilege. United States v. Kovel, 296 F.2d 918, 921 (2nd Cir. 1961); United States v. Cote, 456 F.2d 142, 144 (8th Cir. 1972); Cavallaro v. United States, 284 F.3d 236 (1st Cir. 2002).

B. *Kovel Engagement Agreement*. A written engagement letter is essential. The letter should include:

1. Control. That the accountant is engaged by the attorney and working under the attorney's direction.

2. Negate Pure Return Preparation. That the work is for the purpose of rendering legal advice, not simply for the preparation of tax returns. For example, the accountant is assisting the attorney in determining whether delinquent federal income tax returns should be prepared and filed and what positions to take on them.

3. Ownership. That the work product of the accountant belongs to the attorney.

4. Purpose. That any communications to the accountant are made solely for the purposes of enabling the attorney to provide legal advice subject to the attorney-client privilege.

5. Payment. Provisions for payment to the accountant.

XVIII. <u>THE EIGHT COMMANDMENTS OF CRIMINAL TAX FOR EVERY PRACTITIONER</u>.

A. *Most Frequently Used Criminal Tax Offenses and Defenses*.

1. BASIC OFFENSES AND DEFENSES.

(a) Offenses.

(i) Code §7201 - Attempt to evade or defeat tax (felony punishable by fine of $100,000/$500,000 and/or imprisonment of not more than 5 years per count).

(ii) Code §7202 - Willful failure to collect or pay over tax (felony punishable by fine of $10,000 and/or imprisonment of not more than 5 years per count).

(iii) Code §7203 - willful failure to file return, supply information, or pay tax (misdemeanor punishable by fine of $25,000/$100,000 and/or imprisonment of not more than 1 year per count).

(iv) Code §7206(1) - false and fraudulent statements under penalties of perjury (felony punishable by fine of $100,000/$500,000 and/or imprisonment of not more than 3 years per count).

(v) Code §7206(2) - Aiding or assisting in the presentation or preparation of a false or fraudulent document (felony punishable by fine of $100,000/$500,000 and/or imprisonment of not more than 3 years per count).

(vi) 18 U.S.C. §2(b) - Aiding and abetting an offense against United States (punishable to full extent prescribed for direct violation).

(vii) 18 U.S.C. §371 - Conspiracy to commit offense or to defraud United States (if offense is felony, conspiracy is punishable by fine of $10,000 and/or imprisonment of not more than 5 years per count; if misdemeanor, then punishment limited to provisions for that offense).

(viii) 18 U.S.C. §1001 - Making of known false statement or entry (punishable by fine of $10,000 and/or imprisoned not more than 5 years per count).

(b) Defenses.

(i) General/Policy Based.

(ii) Dual Prosecution.

(iii) Voluntary Disclosure.

(iv) Solicitation.

(v) Age, Health.

(vi) All State - prior civil resolution.

(vii) Reliance on accountant or attorney (full disclosure).

(viii) Technical legal issue. See, U.S. v. Cheek, 882 F.2d 1263 (7th Cir. 1989); U.S. v. Garber, 607 F.2d 92 (5th Cir. 1979); U.S. v. Dahlstrom, 712 F.2d 1423 (9th Cir. 1983).

(c) Evasion Defenses.

(i) No deficiency.

(ii) No affirmative act.

(iii) Failure to file, failure to pay.

(iv) Inability to pay or file.

(v) Good faith belief that could not file, if could not pay.

(vi) Lack of sufficient information to file lowest return.

(vii) Prohibition against debtor's prison.

B. *The Eight Commandments*.

1. First Commandment: Pay your taxes; but if you do not, be wary of friends, partners and lovers.

2. Second Commandment: Retain an attorney who knows both tax and criminal law.

3. Third Commandment: Do not cooperate until you know the facts.

4. Fourth Commandment: Be aggressive and creative in attacking the criminal case.

5. Fifth Commandment: Know what the IRS can get and make it hard for them.

6. Sixth Commandment: Do not waive privileges without knowing it.

7. Seventh Commandment: Discover the government’s case.

8. Eighth Commandment: Try the case or bargain with the civil case in mind.

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