Valuation Issues, Including Planning Considerations for Family Limited Partnerships, Return Preparer Penalties, Defined Value Transfers, and Hot Topics With IRS Estate and Gift Tax Agents

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Introduction

Much of the information in this summary came from comments by various speakers at the 42nd Annual Philip E. Heckerling Institute on Estate Planning. I take no credit for these outstanding ideas discussed at the Heckerling Institute.

1. FLP and LLC Issues

a. Amounts of Valuation Discounts. There have not been any important valuation cases involving FLPs or LLCs in the last year. Audit cases are consistent with the Appeals Settlement Guidelines. Agents argue that discounts should be slotted based on the approach in the McCord, Peracchio, and Lappo Tax Court cases. The lack of control is based on the type of assets, and is determined by reference to closed end funds. Marketability discounts are typically allowed in the range of 20-25%. The IRS allows larger discounts for real estate than for securities. John Porter is seeing that approach argued uniformly throughout the country. In Jelke and Temple, the court allowed only about a 15% lack of marketability discount and IRS agents often point to those cases in settlement discussions, but Daily, Church, and Kelley had much larger discounts.

The amounts of discounts do not depend on the region of the country. John Porter handles FLP cases all over the country, and he cannot discern a pattern of discounts based on the region of the country. Even in the same region, he sees significant differences among agents.

b. Lack of Economic Substance. Occasionally an agent will raise the lack of economic substance argument, based on Estate of Murphy, but it is dropped when the case goes to higher levels. The IRS is no longer making this argument when cases go to court. [SRA Observation: Courts seem to have ruled based on a "smell test" to avoid allowing valuation discounts for mere paper shuffling, and have latched onto §2036 in a few cases where it seems not to apply — such as with the partnership in Bongard where the decedent did not need distributions and no distributions were ever contemplated. One wonders if a court, faced with what it views as an abusive situation but where there was no implied agreement of retained lifetime enjoyment, might be receptive to such an argument at some point.]

c. 2703 and Buy Sell Agreements. The IRS argued in Holman (tried by John Porter in 2005, still awaiting decision), among other things, that §2703 applied to the buy sell agreement. They argued that use of the AFR on the note for a buy-out flunks the comparability requirement of the §2703(b) safe harbor, despite the fact that the AFR is a Congressionally recognized interest rate.

The difference between the buy sell agreement value and fair market value is often not significant. But in Blount, fair market value was double the buy sell agreement price.

d. Gift on Formation; Indirect Gifts. The government is having some success with an argument under Shephard/Senda that the taxpayer made an indirect gift of assets contributed to the FLP (i.e., if assets are contributed to the partnership after children are owners or under an argument that the parties had an integrated plan to contribute assets to the partnership and to make gifts of partnership interests). That argument should (with an emphasis on "should") be easy to avoid by good formation facts. (Make sure the partnership is validly formed, and that the partnership is funded well before gift of partnership interests are made.)

In Holman, the gifts of partnership interests were made eight days after the partnership was funded, but the IRS argued that there were indirect gifts of the contributed assets. (In that case, the government stipulated that the gifts were of partnership interests.) The Holman case was argued in 2005, but the case is still pending.

John advises to wait some period of time before gifts are made. The transaction should work if gifts are made one second after funding. But from the perspective of dealing with IRS, it is best to wait longer, and it is safest to wait into the next year. (In Holman, annual exclusion gifts were made in years two and three and the government did not make the indirect gift argument as to those gifts.)

- Practical Planning Tip About Formalities: John Porter says that the IRS asks about whether capital accounts have been created in every audit. It is something that they look for. It is best to set up capital accounts when the partnership is funded.

e. Section 2036(a)(1).

(1) General Approach; Implied Agreement. This has been the government's silver bullet with respect to poorly operated FLPs and LLCs. There is no one factor that cause inclusion. There is an amalgamation of bad facts in each case, and the court concludes that there was an implied agreed between family members that the senior member can continue to have access to assets in the same manner as if not contributed to the partnership.

- For example, in Rector, there were 40 checks from the partnership to pay the decedent's personal expenses.
- Also, some courts have pointed to personal loans secured by partnership assets. (Bigelow).
- In most of the cases, there have been disproportionate distributions (Korby and Harper said that post death accounting machinations to adjust for disproportionate distributions don't help.)

(2) Recently Tried Case Involving Pro Rata Distributions. John Porter recently tried a case in Philadelphia in which the partnership made pro rata distributions equal to 80-90% of the net income of the partnership. Even pro rata distributions are sensitive to the government — they argue that the distributions reflect a §2036(a)(1) right. John is not aware of any case that said pro rata distributions cause §2036 inclusion, but the IRS is looking at that, especially where the distributions constitute about all of the income. John said that should not trigger §2036(a)(1) because it is a distribution of net income after expenses and holdbacks of amounts needed for reasonable future needs.

(3) Distributions on "As Needed" Basis. A negative factor suggesting a §2036(a)(1) retained right is if the distributions are made on as "as needed" basis, as needed for personal needs of the decedent. Don't do that.

(4) Assets Outside the Partnership. The IRS looks at assets outside the partnership. Most cases are where decedent contributes almost all assets to the partnership. It is easy to conclude the existence of an implied agreement of retained enjoyment of the assets in that situation. John Porter says that taxpayers should be able to argue that partners can rely on pro rata distributions from the partnership — which is like owning Exxon stock and living off the dividends. But the IRS is looking at all distributions — especially when contributions are made to the FLP in old age years. Retain assets outside the FLP to live on. Also consider retaining assets for emergency needs that may arise.

(5) Similarities of Bad Facts. While there have been a variety of §2036 cases that held for the government, most involved "bad facts" cases with some noted similarities:

(a) FLPs created with no negotiation; sometimes by the decedent and sometimes by a child acting under power of attorney with little contributions by others.

(b) Decedent transferred virtually all of his or her assets into the FLP.

(c) During the balance of the decedent's lifetime (sometimes very short, sometimes several years), the distributions are disproportionate to what others get; often not reflected on partnership books, sometimes reflected as loans or payment of management expenses.

(d) FLP often created very close to death. (In Erickson, the court said the daughter "scrambled" to fund the partnership two days before her mother's death.)

(6) "Reasonable" Discount Does Not Shield Against a §2036 Attack. In Rector, the estate claimed a 19% discount, which normally would not garner attention. A problem was that gifts had been reported on gift tax returns that were not reported on the Form 706 as

adjusted taxable gifts, and that got the estate highlighted. (Perhaps the IRS computer picks up on that and triggers an audit, but Carol Harrington says that does not always happen.)

(7) Variations in Legal Tests for §2036 Bona Fide Sale for Full Consideration Exception. Bongard set the base with its "legitimate and significant non-tax reason" test. Subsequent opinions have made a slight modification. In Rector, Judge Laro articulated the test as a "legitimate and significant nontax BUSINESS reason." In Rosen, Judge Laro used: "reason was an important one that actually motivated the formation of that partnership from a business point of view." In Bigelow the 9th Circuit's conclusion referred to "any legitimate, significant non- tax-related business purpose based on objective criteria."

(8) Jeff Pennell's Conclusion About Those Varying Standards. Jeff Pennell concludes: "I don't have any freaking idea what any of these mean. Any commentator who says, 'this is what will work' is pulling it out of their ear, because it is has been a long time since any case said the estate met the standards."

(9) Valid Non-Tax Reasons Have Existed in All Taxpayer Victories. In all of the cases where the estate has won the §2036 issue (Stone, Schutt, Bongard — all John Porter cases), there was a good documentary trail of nontax reasons.

(10) Several Possible Non-Tax Reasons. Some litigators mentioned several possible non-tax reasons that they have seen in some actual situations. One is a situation where a parent was constantly hounded for loans from family members and he wanted to set aside a limited pool of money for loans to family members. He contributed that amount to a partnership. Another situation was a mother who had to help a child following a divorce. The mother had concerns about future support for the child and future divorce claims against the child so formed a partnership. Any such special situations or reasons should be documented.

It is important that the partnership be operated consistent with the reasons for creating the partnership.

(11) Post-Death Use of Partnership Assets. Post-death use of partnership assets has become a hot item — see Erickson, T.C. Memo 2007-107, and Rector, T.C. Memo 2007-367. In Rector, there was a payment directly out of the partnership (on a line of credit) to pay post death expenses. In Erickson, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. The court emphasized the payment of estate taxes from FLP assets as the primary reason supporting its application of §2036(a)(1) (in light of the fact that no distributions were made to the decedent in that case, and no distributions to her from the partnership were anticipated because she had a $1 million bypass trust that could pay her living expenses). That analysis seems wrong, because §2036 refers to retained enjoyment *for life*. (If §2036 applies in that circumstance, then it would also seem to apply to all irrevocable life insurance trusts under the same reasoning—because transfers to ILITs are typically made with the contemplation that the trust will purchase assets of the estate so the estate can use the cash to pay estate taxes.) It would seem that the use of partnership assets after death is irrelevant as to retained right to enjoy assets under §2036 "for life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death" As Chuck Hodges put it: "Courts sometime say that they can also

consider cash flow needs after death. That is wrong, but it is court precedent." In any event, the IRS is clearly looking at it.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations:

(a) It is best is to borrow from a third party. But a bank may be unwilling to do that using only the partnership interest as collateral.

(b) Borrow from an insurance trust or a family entity, secured by the partnership interest.

(c) There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distribution for taxes are made all the time from partnerships, but usually income taxes. John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction) Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases.

[Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses.]

(12) Marital Deduction Mismatch Case. John Porter tried a case in Nov. 2007 (Estate of Samuel Black) involving the marital deduction allowable at the first spouse's death. The IRS argued that the partnership assets were includable in the estate under §2036, but that the marital deduction is allowed only for the value of the partnership *interest* passing to the surviving spouse. We have noted the theoretical possibility of this argument in the past; it is no longer theoretical — the IRS is now litigating this argument.

(13) Creation of FLP by QTIP. John Porter is involved with a case involving the formation of an FLP by the trustee of two QTIP trusts (together with other partners). The case arose after the surviving spouse's death. The IRS argues that the FLP contribution triggered a deemed gift of the QTIP assets under §2519, and that it caused §2036 to apply in the surviving spouse's estate. John argues that is just an investment that the trustee is authorized to make and that it can have no impact on §2036 which requires that the DECEDENT made a transfer.

f. Section 2036(a)(2). Should senior family member serve as the general partner of the partnership? Not many cases have addressed §2036(a)(2) — Kimbell and Strangi. John Porter's preference is that the decedent own none of the general partner interest, and that the decedent got rid of the general partner interest more than 3 years before death. But many senior family members are not willing to contribute assets to an FLP unless they have some say in the management. How should the FLP agreement be planned to avoid §20369a)(2)? John Porter says that under Estate of Cohen, 79 T.C. 1015 (1982), if there are reasonable constraints on the exercise of discretion that can be enforced in a state law proceeding — so that the general partner can't act "willy nilly," § 2036(a)(2) should not apply. Avoid language in the partnership agreement about sole and absolute discretion of the general partner. Also avoid broad exculpatory language for the general partner in the agreement. (A lot of partnership agreements have exculpatory provisions in the boilerplate, but if a senior family member will be a general partner, avoid using exculpatory langue.)

One litigator suggests: If the client demands to have some interest as general partner, try to convince client to put the general partnership interests in an entity, and arrange for the client not to have a controlling interest in the entity. That can also be helpful for some other nontax reasons; for example if the client's son or daughter has investment experience, that child could be the controlling owner of the entity that is the general partner.

The approach of Chuck Hodges in response to a §2036(a)(2) argument: "Show me one case where the government won only on (a)(2)?" [There have not been any yet.] He asks the government's counsel — "Do you think you have the case? Do you want to be the one who loses the next FLP case?"

g. Summary About §2036 Issues. Dennis Belcher concludes that it is a mistake to say that there must be an operating business in the FLP for it to work. "It's like wallabies crossing the Chattahoochee. You just don't want to be the wallaby that gets caught." When you get caught, the result is not good. He concludes that it is essential in FLP planning to control client expectations. The client must understand that FLPs are high audit items. The client should be prepared for zero discounts and be stuck with a locked in entity (and some family members may not agree with wanting to be stuck in the partnership) before the client does this. If a family is willing to take risk, some FLPs work and have worked very well.

Chuck Hodges (a tax litigator from Atlanta) notes that we always say that the losing §2036 cases have "bad facts." That does not mean that FLPs have to have perfect facts, but just better than those bad facts cases. "We know how many cases settle."

John Porter observes that there have only been 18-20 §2036 cases involving FLPs. 99.8 % of these FLP cases get settled before the case goes to trial.

h. Observations From IRS Agent. Marty Basson, Supervisory Attorney, Estate and Gift Taxes, for the Florida Territory of the IRS gave his personal observations about FLP audits. It is always helpful to have a dialogue with IRS representatives to address issues that are of interest to both the IRS and estate planning attorneys. Marty is always very straightforward, and his comments are very helpful in understanding the position of a very experienced IRS agent on issues. Some of Marty's observations are as follows.

(1) FLPs are still a primary issue on estate and gift tax returns. The IRS still sees a fair amount of noncompliance. The IRS sees large revenue results from FLPs (particularly with respect to discounts and §2036) — indicating high noncompliance.

(2) On Appeals, this is a coordinated issue. The IRS wants consistent outcomes. There are Appeals Settlement Guidelines. Any settlements on FLPs should consider the guidelines. There are ranges of settlement, depending on the facts and circumstances. FLP settlements not final until reviewed by national director.

(3) Field exams do not use the settlement guidelines and do not have a national coordinated process.

(4) Marty does not have a copy of the unredacted Appeals Guidelines, nor does he want it. (John Porter, on the other hand, said he would love to see an unredacted copy.)

(5) John Porter reports his experience that agents try to slot discounts under the McCord/Peracchio/Lappo approach, but Marty says that §2036 cases are handled in a very different manner.

(6) Marty says that flunking of the §2036(a)(1) issue often comes from interviewing children and the remaining adult partners. The issue is whether there is an implied agreement that decedent will get the assets if needed. He talks to doctors and looks at their records. He interviews the remaining beneficiaries. He addresses nontax reasons and business purpose. What real benefits do the partners give for creating the partnership? (He had one case where right before death, the decedent finally decided his 74 year old daughter had finally matured to the point that she could manage assets and contributed his assets to the FLP.).

(7) Marty is courteous to witnesses, but he understands that the interview is a stressful environment and he presses on issues. He wants to see how the witness responds under the pressure of the interview to be able to judge the credibility of the witness. In particular, the IRS will explore the intent of the family as to what would be done if the senior family member needed distributions from the partnership in order to meet vital living support needs. Marty will ask the child who is designated as general partner to point out what is debt and equity on the financial statement of the partnership. Sometimes the beneficiaries give almost exactly the same answers word for word. He sometimes wants to ask what card they're reading off of (but he doesn't.) In discussing this with John Porter, Marty emphasized that he wants the answers from the family members, not from John. He knows that John "will give the perfect answer every time."

(8) What kinds of things does Marty look for in audits? There is no scoring system. (Returns are reviewed Florence, Kentucky, to be selected for audit, but the audit decision can be reviewed again before it is assigned to a field agent and the field agent can also look at whether it makes sense to audit the return.) There used to be mandatory selects, but not any more. He emphasizes the purpose of audits is to collect dollars — not just to raise interesting issues. Audits of FLPs result in large revenue collection, but the presence of an FLP on a return is not an automatic audit select. There is not a hit list (but if a particular preparer or appraiser is unreasonable, the agents will review their returns with more scrutiny).

(9) Field agents cannot consider hazards of litigation. "Agents resolve cases; Appeals settles cases."

(10) Just recently, field agents are seeing Appeals Case settlement memos to see what was the outcome and why. It is not appropriate for field agents to be sustained 100%, because Appeals agents consider hazards of litigation that field agents cannot.

(11) At some point, field agents may arrange a pre-appellate conference with Appeals, at which the taxpayer and the taxpayer's representative would be invited. The goal is to get clarity around the facts and the law.

(12) If FLP cases have income tax issues, there is a process to get the case to "the income tax folks."

i. <u>Summary of Differences on View of §2036</u>.

Marty Basson: Section 2036 is based on what is a disguised conveyance rather than a business purpose. Agents are looking at FLPs under §2036 when there is not a "real business" in the opinion of the IRS. The courts are recognizing that these transfers are testamentary in nature. The niceties of conveying the assets do not matter as much as the underlying substance of what is going on.

"Since we've been winning, there is a list of what we're looking at" (but he did not say what that list contains).

Marty acknowledges that attorneys strive to make the FLP look like a business, having annual meetings, minutes of meetings, etc. But that does not make it untouchable under §2036. "Is it a disguised transfer? You guys will make it look right (although I hear that your clients will muck it up)."

John Porter's response: There must also be a retained right (before you even get to the bona fide sale component) and a lack of business purpose or nontax reason should not be enough by itself to trigger §2036(a)(1). No case has focused on the retained right where there was not a bona fide sale. But John acknowledges that if the client has not dotted the i's and crossed the t's and respected the integrity of the partnership, it will be difficult get anywhere with either the (a)(1) issue or the bona fide sale issue.

j. Treat §2036 Cases as Roadmaps to Business Development Opportunities. The §2036 cases are business development opportunities for many attorneys. Use those cases to discuss with clients the need for them to meet with the attorney on a periodic basis, to make sure that the parties understand and comply with partnership formalities. (Some agreements require the distribution of financial statements to partners — which is often not done.) John Porter has had cases where there were capital account requirements that were not satisfied. (Often the lawyer who prepared the agreement doesn't remember some of the mechanical requirements that are in the agreement.)

k. Practical Experiences of Litigators.

(1) Consider Involving Litigation Counsel at Beginning of Audit. Consider bringing in litigation counsel early in the audit. The litigation counsel does not have to be at meeting with the agents, but can be "behind the curtain" and not even on the power of attorney. The litigation counsel can help in planning for the audit, such as helping to make sure that the estate is not turning over the wrong types of documents.

(2) Pay Attention to Correspondence and Documents. The planning for the audit begins at the estate planning level. That's when the contemporaneous documentation is created. That's when the books and records should be created. 95% of the documentation that examining agents look for was created before the date of death. Anticipate the potential audience of the IRS and Tax Court judge when sending out correspondence and memos. The Schutt case is one where contemporaneous communications helped a great deal in the audit.

There are three documents that kill the litigator: Emails, letters, and memos. (When Chuck Hodges has a "bad" document, he enlarges it and puts it up in his office and constantly asks himself "How on earth am I going to live with that?") The attorney should carefully consider what is written in emails, memos to file regarding reasons for the partnership formation, time records (for attorneys/accountants), letters, etc.

There is nothing wrong with documenting tax issues relating to forming the partnership in the context of the nontax reasons. The tax issues can be very complex.

(3) Privilege. Requests are potentially subject to the attorney-client privilege, attorney work product privilege, and tax practitioner privilege. But despite those privileges, the IRS is

clearly trying to get into attorneys files. In every estate tax audit about §2036, the IRS wants communications about the reasons for creating the entity. The attorney must decide whether to assert the attorney client privilege.

(4) Even Privileged Documents Are Often Produced. Those documents often must be produced, even if they would otherwise be privileged. John Porter says that he has tried five FLP cases (and has settled many others). In each of those five, he made the decision to put the estate planning attorney on the stand, which waives any attorney client privilege. Contemporaneous documentation at the time the partnership was formed will come into evidence. It is the best evidence possible to address non-tax reasons for the partnership.

Subject matter waiver: Once you waive attorney client privilege, it is waived as to everything related to that subject.

These documents can be important in persuading an agent in an audit. Marty Basson says that he makes a credibility determination during the interviews with family members. It may be better to be able to give the agent a contemporaneous memo describing the reasons for the partnership that were discussed with the client.

Furthermore, if the government asserts penalties against a taxpayer, the number one defense is that the taxpayer relied on a tax advisor. To use that defense, the client must turn over the legal memo that the client relied on.

(5) Obtaining IRS Documents. The estate has the ability to get the IRS's documents, including their time records and analysis (to the extent not privileged) through a Freedom of Information Act request.

(6) Typical Audit Requests. John Porter attached a typical audit request that is used in both estate and gift tax cases. The requests include such things as the reason the partnership was created, the client's health when it was created, and how the partnership was operated. Books and records, bank accounts, and brokerage records are requested. John sees that type of request in virtually every audit for of an FLP or LLC. While one might argue that motive for creation is irrelevant in gift tax audits, John sees the same type of IRS request for gift tax audits as well.

(7) Treat Audit Requests and Interviews As Discovery for Trial. Anything that is said at the audit is discovery for the trial. As a practical matter, most discovery occurs during the audit. The audit interview is under oath, so treat it as a deposition. An "interview" sounds friendly, but it is under oath and it is really a deposition. Porter gets his client ready like for any deposition. He discusses with witnesses what is likely to be asked. The attorney should decide before the interviews whether to assert the privilege. John Porter wants a court recorder (and the taxpayer has to pay for it). Otherwise, the district counsel just takes notes. He had a case where her recollection was different than the witness. She pulled out her notes and said, "Now didn't you say this…" In another case, the examining agent got on the stand with notes and testified about what was said at the interview. That is very unsatisfactory from an evidentiary level, and John prefers to have a transcript.

Marty's approach with respect to the field agent's notes it to send the notes to the taxpayer's attorney and ask the attorney to review them. It the attorney thinks the notes are incorrect or incomplete, the agent may annotate that.

As to having a reporter, Marty says that the taxpayer must give 10 days notice to have a court reporter or tape the interview. Marty is glad to have a transcript prepared — as long as the taxpayer gives the government a copy.

Marty Basson said that he tries to have a checks and balances system by involving IRS counsel. He likes to bring IRS counsel on interviews. If the case goes to trial, the counsel is the person who has to stand before the judge and is the one who puts family members on the witness stand.

(8) <u>Respond Timely and Fully; Cooperate Reasonably</u>. The IRS is going to be focusing harder in the future on moving audit cases along in a timely manner. That is one criticism they have received. The taxpayer must also help by responding timely and fully to audit requests. John Porter says he tries to put the ball back in the agent's court as soon as possible to speed the process. John says to copy and "Bates stamp" all documents produced because he does not want a question about what was produced.

One of the requirements to shift the burden of proof to the IRS under §7491 is that the taxpayers cooperated with reasonable requests for information.

Furthermore, it is important not to lose credibility with the agent. John Porter: "I like to be hard on the substantive issues and easy on the procedural issues." There is a "double whammy" to being uncooperative. 1) It angers the agent and causes a loss of credibility, and 2) it may impact the burden of proof shift.

Marty says that most taxpayer representatives in audits are cooperative.

(9) <u>Requests of Records or Interviews From Third Parties</u>. The IRS is regularly looking for medical records in estate tax audits. Under federal law, there is no doctor-patient privilege. The agent will send a release form which the attorney or client can give to the doctor. John Porter offers to coordinate that with the IRS. He likes to see the document flow from any third parties to the IRS. If the IRS does not agree, he calls the doctor's office (or other third party), and asks the office to send him a copy of anything the doctor sends to the IRS. John wants to know everything the examining agent knows. (If the IRS wants to meet with a doctor or other third party, John suggests that the person respond that he or she wants to meet in a setting where the estate's attorney is also present.)

The IRS is usually accommodating if the attorney wants to be there. John had one case where the examining agent said no. But the IRS Manual does suggest that if the taxpayer wants to be present for third-party interviews, the taxpayer can be there. In that audit, the agent finally agreed, but stuck the attorneys in two folding chairs at the back away from the interview table.

Marty Basson said his view is that opposing counsel can attend and often can be helpful in filling in the gaps. However, he wants answers from the witness, not from the attorney. (That's when he said he knows John Porter "will give the perfect answer every time.")

(10) <u>IRS Seeking Same Information For Gift Audits</u>. The IRS often seeks information from the estate attorney or others about the non-tax reasons for creating the partnership. The IRS is looking at this type of background information in gift tax audits as well. Why, when §2036 does not apply? The old lack of economic substance argument still floats around. Even in gift case cases, if the IRS can find documentation about gift and estate tax discounts, agents use that to try to hammer a better settlement.

(11) Summons. Two years ago, there were reports at the Heckerling conference that we would be seeing more summonses issued by the IRS, and that there would be a big increased emphasis on enforcement by the IRS. Marty Basson said that he would not issue a summons without first discussing it with IRS counsel to make sure that they are committed to enforcing the summons.

(12) Settlement at Audit vs. Appeals. Five years ago, the general thinking of attorneys was that a better settlement could result by "going up the line" to Appeals or litigation. That is not necessarily true now. The taxpayer will not necessarily get a better result at Appeals.

(13) Capital Accounts. The IRS will look at capital accounts and trace them. Therefore, assets should be valued near the time of contribution to get the accounts correct.

(14) Obtain a Good Appraisal. John Porter says to get a good appraisal and file it with the return. The claimed discount should match what the appraisal says. Some cases have held that the return position is an admission against interest that can be overcome only with clear and cogent evidence. Audit selection does not just depend on the amount of the discount, and the planner should not forego getting a good appraisal by merely claiming a "reasonable" discount

(15) Government Appraisals. John Porter said that he is seeing more in-house appraisers from IRS engineers and economists, and the IRS also sometimes hires outside appraisers.

Marty Basson said that the IRS has a budget for outside appraisals. The in-house appraisal group has received more education and certification so that it will have more credibility. Some judges view IRS in-house appraisers as "tainted". "I'm sorry the Tax Court judges feel that way," Marty says. Agents do not control the engineers who are doing the appraisal. Agents go forward with what the engineers come up with. Marty says that taxpayers hire their appraisers and the IRS sometimes uses in-house appraisers. He doesn't understand why appraisers who are hired by the IRS (albeit in-house appraisers) are treated differently than appraisers hired by taxpayers.

(16) Some Operational and Planning Recommendations From Litigators. Litigators emphasize that planners do not have to do all of the following, but consider them. Each can be helpful in convincing the IRS or a court to accept the partnership.

- Discuss terms of partnership agreement with the client (Typical client response: "I've got to read that thing?").
- Read and understand the terms of partnership agreement.
- Ensure sufficient cash is contributed to the partnership to fund maintenance of any real estate or other non-liquid assets. If not, additional payments of those items by the client may be treated as gifts.
- Review transfer restrictions on assets to be contributed; obtain appropriate consents, if necessary.
- The senior member often contributes 100% of the assets. But if other parties can contribute assets as well, it is better. For example, if the client's brothers and sisters are in the partnership, together with the client's children, they will be looking out for their best interests. (Chuck Hodges says "The belief is that children will listen to their parents, although we know that is not true.")
- Involve the attorney and accountant sooner rather than later in the planning.

- Consider separate counsel for some (or all) participants. That can be a silver bullet for the taxpayer in tax litigation. Get children to engage their own counsel to review your partnership agreement. They may make some changes. If so, document changes that each requests, and have child's attorney keep the letter in his or her file.
- It is helpful to have had negotiations if the IRS argues that §2036 applies.
- Consider compensation to be paid to managers. (The IRS sometimes argues that if the parent fails to take a management fee, that is indicative of §2036, allowing more assets to pass in what has the appearance of a testamentary transfer device.)
- It is helpful if investment policy changes. If not, document explaining why it does not change based on the purpose of the partnership.
- Discuss expected distributions with all partners and what each partner expects.
- Ensure that schedules to the partnership agreement are complete.
- Fund promptly. (Some cases have focused on delay of funding. However, in real life funding on the day the partnership is created is unheard of. Plan to have deeds prepared, brokers alerted, etc to make the funding ASAP — on the day the partnership is created if possible.)
- Ensure the transfer of title to all assets being contributed.
- Have the parties sign transfer documents at the same time as signing the partnership agreement and related formation documents.
- Ensure that partners own the assets to be contributed before the partnership is created.
- Promptly file for the EIN of the partnership; Do not just use the SSN of the senior family member. (Courts have pointed out delays in getting an EIN and setting up bank accounts, saying that reflects that the parties did not respect it as a separate entity.)
- Ensure that partners receive interests in the partnership in proportion to the fair market value of the assets contributed by each to the partnership.
- Consider if a third party who acquires the 1% general partnership interest should pay a higher pro rata value for the general partnership interest. (However, the potential personal liability of the general partner may offset the additional rights that the general partner has.)
- Consider having the partnership reimburse the senior family member who initially paid the set up expenses.
- Does it help to have a charity? Yes, it is an unrelated party with an adverse interest.
- File partnership returns for each year the partnership exists (even if not required to because no income is being produced.) The IRS argued in a case with Stephanie Loomis-Price that if the partnership did not file returns, that is an indicator that it is not being respected.
- File any annual or bi-annual registration statements required by relevant state authorities.
- The IRS always checks with the Secretary of State to see if the partnership is in good standing in the State. In a lot of cases it isn't. That isn't really a big deal, but it looks messy.
- Comply with terms of partnership agreement (Are periodic meetings required? At any meeting, consider taking minutes even if not required. Are annual statements other than

the tax return required? Are annual distributions required? Are payments on preferred interests required?)

- Make any distributions pro rata.
- Make distributions consistently — not just when dad needs money. Regularity of distributions helps — to show the decedent did not just reach in and take money when needed, but that distributions are just the ordinary course of business.
- If you discover a non pro rata distribution, consider a make up distribution, perhaps with interest. The IRS will get everything that has happened involving the partnership within three yearns of death. Rector discussed adjusting capital accounts and fixing problems after death, but it (and other courts) do not give those adjustments much weight. Those problems can be fixed during life. If Exxon sends a check to the wrong person, do they wait 5 years until the person dies? No, they fix it right away.
- Refrain from using partnership assets to satisfy partners' personal obligations.

2. Mirowski v. Commissioner, T.C. Memo. 2008-74; Court Rejects IRS's §§2036(a)(1), 2036(a)(2), 2038, and 2035 Arguments

Synopsis

Decedent (Mrs. Mirowski) signed LLC documents (naming herself as the sole general manager) on August 27, 2001. On 9/01/2001, the decedent transferred 51.09% of the rights under a valuable patents license agreement (that generated revenues of millions of dollars per year) in return for 100% of the member interests of the LLC in which she was named the sole general manager. From 9/5/2001 to 9/7/2001 she transferred marketable securities worth about $62 million to the LLC. On 9/7/2001, the decedent made gifts of a 16% interest in the LLC to each of her three daughters' trusts, retaining the other 52% interest. The decedent retained $7.5 million of personal assets (including $3.3 million of cash and cash equivalents) outside the LLC. The decedent retained assets to pay her living expenses and all obligations except gift taxes on the 48% gift that she intended to make when the LLC was created, but the court concluded that she had the ability to pay the gift taxes (with her retained cash, with loan proceeds from amounts that she could borrow, and from distributions from the LLC attributable to royalties that the LLC would receive).

The decedent died unexpectedly on 9/11/2001, first experiencing a significant deterioration in her condition on 9/10. Thus, during the 16 days before the decedent died, the LLC was formed, contributions were made to it, and the decedent made gifts of 48% of the member interests.

After the decedent's death, the partnership distributed $36.4 million to her estate to cover gift and estate taxes, legal fees and other estate obligations. (Following the decedent's death, the three daughters owned the LLC in equal shares, and they opted not to make pro rata distributions to themselves.)

The IRS argued that the assets in the partnership (including the assets attributable to the 48% interest that was given to the daughters' trusts) should be included in the decedent's estate under §§2036(a)(1), 2036(a)(2), 2038, and 2035(a). The decedent retained assets for living expenses, but the IRS argued that §§2036(a)(1) and (a)(2) and 2038 applied to the contribution of assets to the LLC, and to the 48% gifts of the LLC interests, and that §2035(a) applied to all of the transfers. The court rejected all of those arguments.

As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the court emphasized that the decedent's death was unexpected and that there was no understanding that the LLC assets would be used to pay gift taxes, and the estate taxes were not discussed or anticipated because no one expected the decedent to die any time soon after the transfers. The court did not apply §2036(a)(2) or 2038 even though the decedent was the sole general manager of the LLC at her death. Section 2035 did not apply because neither 2036 nor 2038 applied, so she never relinquished rights that would have otherwise triggered inclusion under §§2036 or 2038.

Key Facts

The result of the case is very fact dependent, and the facts are summarized below in some detail.

(1) The decedent's husband died in 1990, leaving all of his estate to decedent (except $600,000 passing to a bypass trust). The estate included an approximately 73% interest in valuable patent licenses for a medical device that he had invented.

(2) In 1992, the decedent gave 21.78% of the patent license rights equally to trusts for her three daughters, retaining 51.09%.

(3) In 1999-2000, the decedent expressed the desire to provide for her three daughters and grandchildren on an equal basis, and for the daughters to have a close working relationship.

(4) In May 2000, the decedent was first introduced to the concept of an LLC, and documents were sent to her in August, 2000.

(5) In January 2001, the decedent wore a blister on her foot during a trip to France; she developed a foot ulcer as result of the blister and her diabetes.

(6) In March 2001, the decedent had a surgical procedure for the foot ulcer and had various treatments for the foot ulcer between March and August 2001. The doctors discussed various alternatives, including amputation, but the decedent was not comfortable with amputation.

(7) In March and July of 2001, the decedent purchased interests in several retirement communities (suggesting that that she did think that her death was imminent).

(8) In August 2001, there was a family meeting of the daughters where they discussed the LLC and the decedent's intent to make gifts of LLC interests.

(9) <u>Legitimate and Significant Non-Tax Purposes</u>. Based apparently on the testimony of two of the three daughters, the court found that the decedent was aware that "certain tax benefits" could result from the LLC, but they were not "the most significant factor" in the decision to form the LLC. The court found that the decedent had the following legitimate and significant purposes:

"(1) Joint management of the family's assets by her daughters and eventually her grandchildren; (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters trusts; and (3) providing for each of her daughters and eventually each of her grandchildren on an equal basis."

(10) A "legitimate, but <u>not</u> significant, nontax reason" was to provide additional protection from potential creditors, including particularly divorce protection for her daughters.

(11) On August 27, 2001, the decedent signed the LLC documents. The decedent was the sole general manager from the time the LLC was created until the time of her death (16 days later).

(12) On September 1, 2001, the decedent transferred the patents and her 51.09% interest in the patents license agreement to the LLC in return for 100% of the member interests. (No person

other than the decedent made any transfers of property to the LLC.) (The patents license rights were valuable, producing royalties of millions of dollars per year.)

(13) On September 5-7, 2001, the decedent transferred more assets to the LLC, including about $62 million of marketable securities and cash.

(14) Even after the various transfers to the LLC, the decedent retained about $7.5 million of personal property assets, including $3.3 million of cash or cash equivalents. The court found that the decedent "retained more than enough personal assets to meet her living expenses" but did not retain enough to pay anticipated gift taxes attributable to the contemplated gifts of LLC interests.

(15) From the outset, the decedent contemplated making gifts of interests in the LLC after creating it. On September 7, 2001, the decedent gave a 16% interest to each of her three daughters' trusts. The decedent retained the remaining 52% interest in the LLC.

(16) The daughters did not know how the decedent planned to pay the substantial gift taxes (eventually determined to be over $10 million), but she had retained substantial personal assets, including over $3 million in cash and cash equivalents. In addition, the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars a year attributable to royalty payments" from the license rights that were contributed to the LLC. Also, the daughters believed that the decedent could have borrowed against her retained personal assets and her retained 52% interest in the LLC in order to pay the gift tax liability. "At no time before Ms. Mirowski's death did the members of [the LLC] have any express or unwritten agreement or understanding to distribute assets of [the LLC] in order to pay that gift tax liability." There were similarly no discussions about how estate taxes would be paid because at no time before September 10, 2001 did the doctors, the decedent or her family expect her to die.

(17) Despite the finding immediately above that the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars", the court found that there was no express or unwritten agreement or understanding among members of the LLC that the decedent, at her own discretion, could have access to assets she had transferred to [the LLC], the right to income from those assets, or the right to determine who can possess or enjoy those assets.

(18) The decedent was admitted to the hospital for more treatments on her foot ulcer beginning on August 31, 2001. However, until September 10, everyone thought that the treatments would allow her to recover and return home. The decedent discussed with a daughter who lived in Philadelphia that she planned to travel to her home on September 18 for a Rosh Hashanah celebration. Another daughter left the country to attend a medical conference on September 6.

(19) The decedent's medical condition deteriorated significantly on September 10. The doctors recommended amputation to avoid further complications including possible life-threatening infections. The decedent refused, and she developed "sepsis, caused by an overwhelming infection of the blood stream. The decedent died the next day, September 11, 2001 [yes, *that* September 11].

(20) In 2002, $36.4 million was distributed from the LLC to pay transfer taxes, legal fees, and other estate obligations. (The decedent's will left her 52% interests in the LLC equally to her daughters' trusts, so they would own 100% of the LLC interests. The daughters decided not to make pro rata distributions to themselves. "In making that decision, [the daughters] had in mind that those members will own collectively 100 percent of [the LLC], in three equal shares, after decedent's estate is closed.")

(21) The estate filed a gift tax return reporting $9.7 million of gift tax. Eventually, the gift tax was settled, increasing the value of each 16% interest from $5.7 million to $6.8 million (see footnote 36).

(22) The estate filed an estate tax return reporting estate taxes of $14.1 million. The IRS proposed to increase the gross estate from $27.8 million to $71.1 million and increase the estate tax by $14.2 million.

Holding

Sections 2036(a)(1), 2036(a)(2), and 2038 do not apply to the contribution of assets to the LLC or to the LLC assets attributable to the 48% member interests that were given to the daughters' trusts. Section 2035 does not apply, in light of the fact that the decedent did not relinquish any rights or powers that would otherwise have triggered inclusion under §§2036 or 2038.

Analysis

1. Burden of Proof. Neither party addressed §7491(a), and the court concluded that the resolution of the issues does not depend on who has the burden of proof.

2. Application of §2036 and §2038 to Contributions From Decedent to LLC.

    a. Bona Fide Sale For Full Consideration Exception.

        (1) Legtimate and Significant Nontax Reasons. While the decedent was aware of potential tax advantages, they were not the "most significant factor" in the decision to create the LLC. The court cited the "legitimate and significant nontax reason" test from Bongard, and found that the decedent had three legitimate and significant nontax reasons.

        - Joint management. The decedent wanted her daughters and eventually her grandchildren to jointly manage the family assets, based on her family background of working together in a family business.
        - Single pool of assets. The decedent wanted to maintain her assets in a single pool for her daughters to allow for investment opportunities that would otherwise be unavailable. Indeed, certain investment opportunities at Goldman Sachs would not have been available if the assets had been separated among the daughters and their trusts.
        - Equal provisions. The LLC assisted with the decedent's goal of providing equally for her daughters, and eventually her grandchildren.

        [*Observe that these are pretty common goals. These same reasons potentially could apply in many family situations*.]

        Creditor planning. Creditor planning was an additional "legitimate but not significant" nontax reason, particularly providing possible divorce protection for the daughters.

        (2) Credibility of Witnesses. Apparently, the nontax reasons were established by the testimony of two of the daughters. No documentary evidence of these reasons were mentioned in the opinion. The IRS argued that their testimony should be disregarded, because of their personal interest. However, the court found the witnesses to be credible, based on their "candor, sincerity, and demeanor" as well as the "reasonableness' of their testimonies. The court found them to be "completely candid, sincere, and credible."

(3) IRS Counter Arguments As to Bona Fide Test. The IRS restated some of the standard reasons that have been cited in prior cases.

- Failure to retain assets for anticipated financial obligations. The court found that the only anticipated significant financial obligation when the decedent formed and funded the LLC was a substantial gift tax that would be attributable to the contemplated gifts of member interests. However, there was no express or unwritten agreement or understanding to distribute LLC assets to pay the gift tax liability. The decedent could have (i) used a portion of her remaining $7.5 million of personal assets that she retained, including cash and cash equivalents of over $3.3 million, (ii) used a portion of the distributions "that she expected to receive as a 52-percent interest holder in [the LLC] of the millions of dollars of royalty payments… that she expected {the LLC] to receive," and (iii) borrowed against her personal assets that she retained and her 52% interest in the LLC.

  As to estate tax payments, the court observed that at no time before September 10, 2001 did the decedent, her daughters, or her physicians expect her to die. Consequently, "at no time did Ms. Mirowski and her daughters discuss or anticipate the estate tax and similar transfer taxes and the other estate obligations that would arise only as a result of Ms. Mirowski's death."

- Lack valid functioning business operation. The court concluded (i) that the LLC has at all times been a valid functioning "investment operation and has been managing the business matters related to the …patents." Moreover, the court rejected the suggestion that the activities of the LLC "had to rise to the level of a "business' under the Federal income tax laws in order for the exception under section 2036(a) …to apply."

- Delay in forming and funding the LLC until shortly before death. The court responded by noting that the decedent was not expected to die before her health quickly and unexpectedly deteriorated on September 10.

- "Sat on both sides." The IRS repeated the statement, that has been included in various cases (but has never appeared to be a determinative factor, but just one of many listed by a court in what the court perceives as an abusive situation), that the decedent "sat on both sides" of the transaction (apparently meaning that there was no negotiation. The court responded that would eliminate single member LLCs from the statutory exception. Furthermore, the court noted that only the decedent contributed assets to the LLC, apparently intimating that it is totally expected that only the sole contributing member of the entity would make decisions about its terms.

- Post-death distributions. The IRS argued that the post-death distribution of $36.4 million keeps the transfer to the LLC from meeting the bona fide sale exception. The court responded that her death was not expected, so the decedent and the daughters never discussed or anticipated providing for the estate taxes and estate obligations. Perhaps more important, the court seems to suggest that failing to keep enough assets to pay estate taxes does not necessarily negate the applicability of the exception:

  > "Moreover, we reject the suggestion … that respondent's contention … is determinative in the instant case of whether Ms. Mirowski's transfers to [the

LLC] were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a)."

(4) Full Consideration Requirement. The court finds that the Bongard standard is satisfied: (i) The decedent received interests proportionate to her transfers (i.e. 100% in this case); (ii) her capital account was credited with her transfers; and (iii) on liquidation or dissolution she had the right to receive property in accordance with her capital account.

(5) IRS Counter to Full Consideration Requirement. The IRS's countering argument is a twist on its "gift on creation" and its "integrated transaction" theories. The IRS argued that because the decedent always intended to make gifts of 48% of the LLC interests, she did not receive full consideration for her transfers to the LLC. The IRS does not use the phrase "integrated transaction," but that is the effect. The court disagreed, treating (i) the transfers to the LLC in return for 100% of the member interests, and (ii) the subsequent gifts of member interests as separate transactions. The full consideration requirement is satisfied as to the contribution to the LLC if proportionate interests are received in the first step.

b. Section 2036(a)(1) and (a)(2) and §2038 Retained Interests and Powers. The court said that it did not have to address whether there were retained interests under §§2036(a)(1) or (a)(2) or 2038 as to the transfers to the LLC because the bona fide sale exception applied. (The §§2036 and 2038 issues are discussed more fully below as to the transfer of the 48% member interests, because the bona fide sale exception does not apply to those transfers.)

3. Application of §§2036 and 2038 to Transfer of 48% Interests by Gifts. The court separately analyzed the application of §§2036and 2038 to the subsequent gifts of LLC interests. (All too often, courts have addressed whether to include all FLP or LLC assets in the estate under §2036, even as to assets attributable to gifts of FLP or LLC interests, without addressing how the string statutes would apply to the gifts. Even if §§2036, 2038, or 2035 apply, one possible approach would be to bring back the transferred interest into the estate—i.e. the discounted LLC interest in this situation. The court does not address that approach.

a. Bona Fide Sale Exception Not Applicable. The court easily concludes that the bona fide sale for full consideration exception does not apply, because these transfers are gifts, and obviously were not made for full consideration.

b. Section 2036(a)(1), Express Agreement. The IRS apparently argued that the decedent the right under the operating agreement to cause the distribution to herself of all income and assets of the LLC, even including income and assets attributable to the 48% interests that were given to the trusts. The IRS says there is an express agreement that the decedent would continue to retain the possession or the enjoyment of or the right to income attributable to the 48% member interests that were given to the daughters' trusts because the decedent was the general manager, and the general manager had sole authority to manage the LLC affairs, including the authority to determine the timing and amounts of distributions. The LLC operating agreement says that except as otherwise provided, "the timing and the amount of all distributions shall be determined by the Members holding a majority of the Percentages then outstanding."

The court responds that the general manager has a fiduciary duty under state law. Also, other provisions of the operating agreement require pro rata allocations of profit and loss and pro rata distribution of capital proceeds from capital transactions. Furthermore, the authority to determine the timing and amounts of all distributions was a power given to the majority members, not the general partner.

Even as to the decedent's authority as the majority holder of the member interests, the section referring to determining the timing and amounts of distributions is subject to other provisions of the operating agreement, including pro rata distribution of "cash flow," pro rata allocation of profit and loss and pro rata distribution of capital proceeds from capital transactions.

c. Section 2036(a)(1), Implied Agreement. The IRS argues there was an implied agreement of retained possession or enjoyment or income attributable to the 48% interests that were given to the daughters'' trusts because of the post mortem distribution of $36 million to the estate in order to pay transfer taxes, legal fees and estate obligations. The court responded that the decedent's death was not anticipated at the time of the transfers, and there was no understanding to make LLC distributions to pay the gifts taxes or other amounts due after her death.

The court did not specifically address what suggested an implied agreement that the decedent somehow kept the right to receive assets attributable to the daughters' interests, when her own 52% interest was sufficient to fund the $36 million of distributions.

The $36 million was paid as a "distribution" from the LLC, and was not accomplished by purchasing assets from the decedent's estate or redeeming some of the estate interests (as was done in the Erickson case.) Even so, the court disagreed that the post-mortem $36 million distribution evidenced an implied agreement of retained enjoyment of assets attributable to the 48% interest that had been given to the daughters' trusts. The court acknowledged that there were not pro rata distributions to the other members, but noted that was a decision by the daughters in light of the fact that their trusts would equally own 100% of the member interests in the LLC after the decedent's estate was settled.

d. Section 2036(a)(2). The IRS argued that the decedent kept the right to designate who could possess or enjoy the transferred property or the income therefrom as to the 48% interests that were given to the daughters' trusts. The IRS points to the decedent's right to dispose of assets in the ordinary course of business (with the approval of the daughters), and the decedent's power as majority member owner to determine the timing of the distribution of capital transaction proceeds. *[Observe: The IRS does not argue that merely being the sole general manager of an LLC results in keeping proscribed powers under §2036(a)(2).]* The court said that it rejects that argument for the same reasons it gave for the similar argument as to the express retention of a §2036(a)(1) right under the same general reasoning.

e. Section 2038. The issue is whether the enjoyment of the transferred property (i.e., the gifts of the 48% interests) was subject o a change exercisable by the decedent alone or in conjunction with another person to alter, amend, revoke, or terminate within the meaning of §2038(a)(1). The IRS gave the same reasons as under its §2036(a)(2) argument, and the court summarily rejects the arguments for the same reasons as under the §2036(a)(2) analysis.

4. Section 2035. Because §§2036 and 2038 do not apply as to any of the transfers, §2035(a) cannot apply, because it only applies to the relinquishment of powers that would otherwise cause inclusion under those sections (or §§2037 or 2042, neither of which are applicable).

Observations

1. Transfer Shortly Before Death. Most of the FLP and LLC §2036 cases have involved the creation of FLPs/LLCs shortly before the decedent's death. This case continues that pattern, with the entire formation, funding, and gifting occurring within only 16 days of the decedent's death. That appears to be a common them of situations that the IRS chooses to take to court. However, in this case the court found strong evidence that the decedent's death was not anticipated with the LLC was formed and funded or when the gifts were made.

2. Section 2036 Exception Applies If It Is Discussed First In The Opinion. Some planners have noted that if the §2036 bona fide sale exception is discussed in the opinion before the retained interest issue, the court finds that the exception applies. If the court first discusses the retained interest issue, it will ultimately find that the exception does not apply (and the court finds the existence of retained §2036 rights because courts seem to apply the same general standards for determining the existence of a bona fide transfer and the existence of an implied agreement of retained enjoyment.) That pattern continues with this case. The exception is discussed first, and the court finds that it applies.

3. Significance of Tax Advantages Not Being "The Most Significant Factor." The court found that the tax advantages were not "the most significant factor" in the decision to form and fund the LLC. Is that vital? What if there were "legitimate and significant nontax reasons, but tax savings was the "most significant factor?" Would that mean that the exception could not apply? Thus far, no court has specifically imposed that requirement.

   Perhaps this principle is being applied by the courts but in a non-explicit manner. Generally speaking, the same reasons that are recognized as "legitimate and significant nontax reasons" in this case have been rejected in other cases that the court perceived as abusive (where the court perceived that the parties were making transfers of almost all of the decedent's assets shortly before death just to get an estate tax valuation discount.) Perhaps it is the fact that the tax reason totally dominates, that the court finds that the other nontax reasons are not "legitimate and significant."

4. Legitimate and Significant Nontax Reasons. Planners often search to find what nontax reasons will be viewed as acceptable by the courts. This is obviously a fact intensive issue, considering all of the surrounding circumstances. However, it is comforting to planners that the reasons that were accepted in this case would apply in many family situations (i.e., joint management, keeping assets in a single pool rather than dividing the assets among estate beneficiaries to facilitate investment opportunities, and to facilitate providing equally for descendants).

5. Creditor Planning. The court continues the record of almost all courts in failing to find creditor planning as a legitimate and significant reason. Unlike some cases, the court does not question that there can be legitimate creditor planning advantages of using LLCs, but the court just finds that on the facts of this case, that was not a significant reason.

6. Facilitating Gift Giving. This is the first case that has recognized that reasons to facilitate making gifts and distributions among descendants in an advantageous manner can be a "legitimate and significant reason" to support a finding that the bona fide sale exception applies. Bongard found that facilitating giving was not a nontax reason under the facts of that case, and some other Tax Court Memorandum cases have subsequently said that facilitating giving can never be a legitimate and significant nontax reason. However, the three nontax reasons recognized in this case all relate to being able to divide one's assets among

distributees in an effective way. None of the three reasons directly aid the decedent during her lifetime. All three provide perceived advantages for her children (i.e., allowing the daughters to jointly manage the assets, allowing the daughters to have the benefit of a large single pool of assets by keeping all of the decedent's assets in a single pool, and facilitating equal division of the assets).

Footnote 45 directly addresses the "facilitating gifting" issue:

"In Estate of Bongard, we did not conclude that an intention to facilitate lifetime giving may never be a significant nontax factor. Rather, we found on the record presented there that such an intention was not a significant nontax reason for forming the partnership involved in that case."

7. <u>No Business Purpose Requirement</u>. Despite several judges failure to convince a majority of the Tax Court in <u>Bongard</u> to impose a business purpose requirement to satisfy the "bona fide sale" requirement in the §2036 exception, some judges have continued to restate the standards of the exception as requiring a business purpose. (For example, see the <u>Rosen</u> and <u>Rector</u> cases.) Judge Chiechi explicitly repudiates the necessity of requiring activities that rise to the level of a "business" to meet the §2036 exception.

8. <u>No Outside Contributions to Partnership</u>. Planners often debate whether it is better to have third parties make contributions to the partnership. Doing so can benefit the decedent during his or her lifetime, and may provide another nontax reason for forming the LLC or FLP. Furthermore, the Ninth Circuit opinion in <u>Bigelow</u> literally required that there be a joint pooling of assets—which would require substantial contributions by others (even though that did not happen under the facts of that case and the court did not point out that fact.) Judge Laro's opinion in <u>Rector</u> seems to disregard the <u>Bongard</u> analysis of what is required to constitute full consideration, and instead looks to whether there is a change in the underlying pool of assets or prospects for profit. That would also seem to require outside contributions.

   In <u>Mirowski</u>, there were no contributions from third parties, and the court still upheld the LLC against an attack under §2036.

9. <u>No Negotiations; Only One Attorney</u>. Some courts (including the Eight Circuit in <u>Korby</u>) have listed various factors supporting the failure to apply the bona fide sale exception, including "standing on both sides of the transaction" and the fact that only attorney represented all participants. The court specifically rejected the "standing on both sides of the transaction" argument in <u>Mirowski</u>, but it was a single member LLC. Also, no mention was made of the fact that one attorney planned the transaction, knowing the agreement was being prepared with the contemplation that the daughters' trusts would quickly receive member interests by gift.

10. <u>Requirement to Distribute Cash Flow</u>. The operating agreement requires the distribution of cash flow, which is defined as meaning cash flow after retaining reasonable reserves. Some planners question whether that increases the likelihood of an attack under §2036(a)(1). We cannot tell much about that from this case, because the court did not address §2036 as to the contributions to the LLC in light of the fact that the §2036 exception applies. However, the existence of that requirement, rather than just giving the manager the discretion to make distributions, appears to have helped with the §2036(a)(2) and 2038 arguments. The IRS tried to force an argument that a power to determine the timing and amount of distributions somehow constituted a §2036(a)(2) or 2038 power over the transferred LLC interests. The

court found that provision to be subject to other provisions of the agreement, all of which contemplated pro rata distributions under a fiduciary duty.

11. Discretion to Determine Holdback For Reserves Before Distributing Cash Flow. Footnote 62 indicates that the IRS argued that the decedent had the power to determine how much cash flow and capital proceeds would be distributed by reason of the general manager's power to determine reasonable reserves. The court responded, first, that the discretion in determining reasonable reserves "was limited to establishing reserves for MFV's liabilities and obligations and future expenses, debt payments, capital improvements, and replacements." Second, the decedent's authority to establish reserves "was subject to the fiduciary duties imposed on her by Maryland law." The court found nothing in the record suggesting that the decedent would have established reserves in violation of those duties. The court concluded that the decedent's power "as general manager to establish reserves as specified in MFV's operating agreement did not give Ms. Mirowski an interest or a right described in sec. 2036(a)(1) (or sec. 2036(a)(2))."

12. Decedent as Sole General Partner. Planners generally avoid having the decedent serve as the sole general partner. However, that did not prevent a taxpayer victory in this case. In fact, the IRS did not even seem to argue that merely being the sole general manager (or the sole general partner in an FLP context) itself would be sufficient to invoke §2036(a)(2) or 2038. The court emphasized the limitations on the general manager's powers under the agreement and emphasized the fiduciary duties that applied to the general manager under state law. However, until there is more specific and general repudiation of Judge Cohen's reasoning in the Strangi Tax Court opinion, cautious planners will continue to advise clients not to serve as the sole general partner of an FLP or manager of an LLC.

13. Anticipated Distributions of LLC Income. Planners often ask if the entity should be able to distribute income receipts, similar to the way that the decedent would be able to receive dividends from stock that the decedent purchases. Some courts have pointed to the fact that any distributions were made to the decedent as reflecting an implied agreement of retained beneficial enjoyment of the FLP assets. In this case, the court specifically acknowledged that the decedent anticipated receiving distributions attributable to her share of the millions of dollars of royalty payments that would be made each year to the LLC. The court used that as supporting that the decedent had a method for paying anticipated expenses when the LLC was formed (i.e., the large gift tax liability) without having to access capital of the LLC.

    However, planners cannot rely being able to expect distributions of LLC income without impacting the determination of an implied §2036(a)(1) right to beneficial enjoyment, because the court did not reach the §2036(a)(1) analysis as to the contributions to the LLC. (The court only discussed §2036(a)(1) as to the gifts of member interests, where the issue is whether there was an implied agreement to receive distributions of income or other assets attributable to the interests that had been transferred by gift.)

    Nevertheless, it is an interesting situation that the court found that the decedent in this case anticipated receiving substantial distributions of income from the LLC, yet the LLC still passed muster under §2036 (albeit because of the §2036 exception).

14. Not Retaining Enough Assets to Pay Anticipated Liability Directly From Retained Assets. A standard §2036 argument by the IRS is that the decedent did not retain sufficient assets to pay living expenses and other anticipated expenses. Here, the court said that the decedent did retain enough assets to provide for her living expenses, but did not retain enough assets to pay directly for her anticipated gift taxes. The court pointed to fact that (i) there was no

understanding that the LLC would make large distributions so that she could pay her gift taxes, and that (ii) she had other means of coming up with funds to pay the gift taxes, including anticipated large distributions from the LLC itself from royalties that would be paid to the LLC.

As with post-mortem distributions to pay estate taxes (discussed immediately below), the case will be cited by planners as rebutting the Erickson and Rector citations by IRS agents that use of FLP assets to pay transfer taxes creates an implied §2036 retained right.

Again, keep in mind that the case does not directly hold that distributions to pay gift taxes cannot evidence an implied agreement of retained enjoyment—because the court did not address whether there was a retained enjoyment under §2036 as to contributions to the LLC in light of the fact that the §2036 exception applied.

15. Post Mortem Distributions to Pay Transfer Taxes, Legal Expenses, and Estate Obligations. There are reports that IRS agents are not scouring FLP records to determine if any FLP assets have been used post mortem to pay estate taxes, in light of the Erickson and Rector cases. Erickson involved a situation where the FLP purchased estate assets and redeemed some of the estate's FLP interests, rather than having distributions of FLP assets to the estate, and the court relied primarily on the post mortem use of FLP assets to find the existence of an implied agreement of retained enjoyment under §2036. The court reasoned that people know they will eventually die and that there will be obligations after their deaths, so planning to use FLP assets to satisfy anticipated liabilities after one's death is a §2036 retained right. While Mirowski does not hold that post mortem use of LLC asset to pay estate taxes is not a §2036 retained right (in light of the fact that the §2036 exception applies so the court did not address §2036(a)(1) as to the contributions to the LLC), it is nevertheless an indication that post-mortem use of FLP/LLC assets to pay estate taxes is not necessarily fatal under §2036.

16. Repudiation of "Integrated Transaction" Argument. The IRS has on occasion made the argument that funding of an FLP must be coupled with the intention to make gifts in an integrated transaction analysis to treat the transaction as an indirect gift of the assets themselves. The IRS made a variation of that argument in Mirowski by saying the intention to make gifts meant that the transfer was not for "full consideration" and did not satisfy the §2036 exception. The court specifically rejected that approach, treating the transfer to the LLC and the subsequent gifts as two separate transfers for purposes of determining if full consideration was received.

17 Glitch In Income Tax Reporting Is Not Fatal. Footnotes 32 and 46 indicate that the income tax return for 2002 (when the LLC made a large distribution just to the decedent's estate to pay the transfer taxes and other estate expenses) erroneously reported that the distribution was charged against the respective capital accounts of the members on a pro rata basis. The court merely observed that the record did not indicate why the return contained that error, but concluded that it did not find "that error to be a material factor in our resolving the issues presented."

18. Coloring of the Facts. As with most of the FLP cases, reading the court's summary of the finding of facts clearly telegraphs which side will win. It was readily apparent reading the court's summary of the facts in Mirowski, before getting to the substantive opinion, that the taxpayer would win the case.

19. Appealable to Seventh Circuit. One of the two personal representatives reside in Indiana (appealable to the Seventh Circuit) and the other resides in the United Kingdom. Presumably, appeal will lie to the Seventh Circuit (if the IRS chooses to appeal the case).

3. Return Preparer Penalties

a. Elevated Standard Under §6694.

Section 6694 is amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50% likelihood of success) to avoid penalties. I.R.C. §6694(a)(2)(B). If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard. I.R.C. §6694(a)(2)(C).

Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b)(2). In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return. I.R.C. §7701(a)(36)(A); Reg. §301-7701-15(a). (An example in the regulations suggests that giving advice regarding the treatment of a "significant" item on the return constitutes preparation of a "substantial portion" of the return. Reg. §1.6694-1(b)(3).) The definition of a nonsigning "return preparer" who only gives advice on specific issues of law is described in Regulation §301.7701-15(a)(2). An important limitation is that a nonsigning preparer is limited to someone who gives advice "with respect to events which *have occurred* at the time the advice is rendered and is not given with respect to the consequences of *contemplated* actions." Id. (emphasis added).

b. Notice 2008-13. Notice 2008-13, which provides interim guidance regarding the return preparer penalties, reiterates that the standard is applied as of the date the return is signed (for a signing preparer) or the date advice is given (for a nonsigning preparer). The Notice makes clear that "the regulations expected to be finalized in 2008 may be substantially different from the rules described in this notice, and in some cases more stringent." Highlights of the interim notice regarding the reporting standards include:

(1) More likely than not standard. This standard is met if the preparer analyzes the pertinent facts and authorities in the manner described in the current regulations (§1.6662-4(d)(3)(iii)) and reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS (not taking into account the possibility that the return will not be audited, that the issue will not be raised on audit, or that the issue will be settled.) The preparer "may rely in good faith without verification upon information furnished by the taxpayer as provided in §1.6694-1(e) … [and] on information furnished by another advisor, tax return preparer or other third party…The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete."

A very important example, (which, rumor has it, was included at the request of accountants), is Example 10 in Section H of the Notice, which provides an "impossible to make a precise quantification" exception:

"Example 10. A corporate taxpayer hires Accountant J to prepare its tax return. Accountant J encounters an issue regarding various small asset expenditures. Accountant J researches the issue and concludes that there is a reasonable basis for a particular treatment of the issue. Accountant J cannot, however, reach a reasonable belief whether the position would more likely than not be sustained on the merits because it was *impossible to make a precise quantification* regarding whether the position would more likely than not be sustained on the merits. The position is not disclosed on the tax return. Accountant J signs the tax return as the tax return preparer. The IRS later disagrees with this position taken on the tax return. Accountant J is not subject to a penalty under section 6694."

(2) <u>Reasonable basis</u>. The reasonable basis standard will be interpreted in accordance with the current regulations (§1.6662-3(b)(3)).

(3) <u>Reasonable cause and good faith</u>. The reasonable cause exception in the statute was not changed (i.e., "reasonable cause for the understatement and such person acted in good faith"). Notice 2008-13 changes the "reliance on advice" rules in §1.6694-2(d)(5). A preparer acts in good faith "when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice." The advice may be written or oral (but the burden of establishing the advice is on the return preparer). However, the advisor's reliance is not in good faith if (i) the advice is unreasonable on its face, (ii) the preparer knew or should have known that the third party was not aware of all relevant facts, or (iii) the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given.

(4) <u>Disclosure for signing preparers</u>. The interim guidance gives some additional exceptions (in addition to disclosure on a Form 8275 or 8275-R) to satisfy the disclosure requirement in order to lower the standard to the reasonable basis standard: (1) providing the taxpayer with the prepared return that includes the appropriate disclosure [presumably even if the taxpayer does not actually include the disclosure with the return that the taxpayer actually files]; (2) "If the position would otherwise meet the requirement for nondisclosure under section 6662(d)(2)(B)(i) [i.e., if there is "substantial authority," which is the standard for the taxpayer to avoid penalty without disclosure (and which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits)], the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided;" or (3) "If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) [which applies to "tax shelters"], the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided." [*OBSERVATION: This is the IRS's response to the ethical problem that professionals have raised in light of the inherent conflict that preparers have in representing clients because the standard for the preparer to avoid penalties is higher than the standard for the taxpayer to avoid penalties. If the "substantial authority" standard is satisfied, so that the taxpayer does not have to disclose to avoid penalties, the preparer can avoid penalties by merely advising the taxpayer of the difference between the penalty standards applicable to taxpayers and preparers. Stated differently, if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial*

authority" standard. Presumably, preparers will begin giving that notice on a routine basis to all taxpayers. Keep in mind, however, that the IRS observed that the final regulations may adopt rules more stringent than the rules described in the Notice.]

(5) Disclosure for nonsigning preparers. The nonsigning return preparer can use the lower reasonable basis standard "if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure." [*OBSERVATION: This is very helpful, because the advisor otherwise would have to assume that the higher "more likely than not" standard would always apply, because the advisor would have no way of guaranteeing that the return as actually filed would include disclosure. It is interesting that this option was effectively removed from the analogous Circular 230 rules under the amendments proposed last fall. Hopefully, the IRS will add this provision back into the revisions of §10.34(a) of Circular 230 and remove the requirement that the taxpayer actually disclose in order to get the benefit of the lower reasonable basis standard as long as the advisor advises the taxpayer of the standards and disclosure requirements for the taxpayer to avoid penalties.*] If a nonsigning preparer gives advice to another preparer, the nonsigning preparer can use the lower standard "if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required." If the advice is in writing, the statement must also be in writing, but the advice and statement may both be oral. "Contemporaneously prepared documentation in the nonsigning tax return preparer's files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer."

c. Conflict of Interest. Part of the negative reaction relates to the fact that the standards in §6694 creates an inherent conflict of interest between professionals and their clients. Taxpayers are only subject to a "substantial authority" standard (which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits) for undisclosed positions and a "reasonable basis" standard (which the Joint Committee on Taxation says is approximately a 20% likelihood of success on the merits) in order to avoid penalties under §6662. Preparers are subject to the more stringent "more likely than not" standard under §6694, thus creating the inherent conflict. (One reaction has been the submission of a bill that would increase the taxpayer penalty standards to the "more likely than not" standard as well.)

In Notice 2008-13, the IRS responded to this concern with a rule providing that if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial authority" standard (so that the same standard would apply to both). Presumably, preparers will begin giving that notice on a routine basis to all taxpayers. See the discussion above about the changes under Notice 2008-13.

d. Unrealistic Standard. The major concern is that a "more likely than not" standard is unrealistic in the tax world where there are so many factual and legal uncertainties.

"The more significant problem with this revision is that Congress did not take into account the fact that a practitioner often will not be able to determine whether a position is more likely than not correct. There are no clear answers to numerous common issues with respect to items reported on tax returns … [N]ow the preparer would need a much higher level of certainty concerning the correctness of the position taken on the return.

This is particularly a problem for factual issues… Since many factual issues reasonably may be viewed in more than one way, as long as the position taken by the return preparer was solidly grounded in the facts, there was little risk that the preparer would by subject to a penalty even if the IRS ultimately determined that there was an understatement of liability." Lipton, What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, J. TAX'N (Aug. 2007).

e. Observations of Carol Harrington. Disclosure must generally be made on Form 8275 (or 8275 R if disregarding a regulation) to reduce the reporting standard. Carol suspects that they are going to be so common that preparers may just throw them in on every return. [Currently, some say that filing a Form 8275 draws an automatic audit. Presumably that will change if Form 8275s become commonplace.]

The IRS does not know what to do about mismatch between the preparer standard and taxpayer standard to avoid penalties. Preparers have a higher standard; they have to tell clients to disclose, but clients don't have to disclose in order to avoid taxpayer penalties as long as there is "substantial authority."

Notice 2008-13 says that preparers can get the benefit of the lower standard by just providing a taxpayer a return with the disclosure statement. The preparer does not have to follow the taxpayer to the post office to make sure he files it with the disclosure statement included. [In addition, the Notice gives other alternatives for getting the benefit of the lower standard — as long as there is "substantial authority" for the position.]

This is serious. "More likely than not to be sustained on the merits" is a high standard; "substantial authority" is about 40%, and "reasonable basis" is about one-third. The difference between "reasonable basis" and "more likely than not" is enormous. Carol concludes "This is a new world."

Ralph Lerner's take on the new rules: "I look around this room and it's a nightmare — It's like I'm looking at thousands of deputy IRS agents." -Ralph Lerner

4. Defined Value Transfers

Carlyn McCaffrey presented some unique creative ideas for defined value transfers at the 2008 Heckerling Institute.

a. Transfer Planning Advantages.

(1) The gift tax annual exclusion protects against gift tax, estate tax and GST tax.

(2) Gifts are removed from the estate tax base if made at least three years before death.

(3) Future appreciation is removed from the estate.

(4) If transfers are made to a grantor trust, the grantor can pay the income tax.

(5) Transfers of fractional interests or interests in investment or business entities can produce valuation discounts.

b. Major Risk of Gifts and Sales. There is always an inherent risk of how transfers are valued for transfer tax purposes (unless the transfer is of cash or marketable securities), and the best candidates for lifetime transfers (i.e., with the greatest appreciation potential and the potential for discounts) are often hard to value assets.

In Stone, the court allowed only a 5% discount for a 50% fractional interest in art. (Despite this one decision, art owners might still want to make fractional gifts of art using a "more realistic" discount than 5%. Justification for a higher discount is that there is no guarantee that the owner of a fractional interest will ever find a buyer. In any event, the case has given the IRS more enthusiasm in going after fractional gifts of art.) The Stone case illustrates the inherent gift valuation risk.

c. Overview of Alternatives to Deal With the Substantial Valuation Risk. Alternatives include: (i) GRATs, (ii) transfers with formula "defined value" clauses, and (iii) transfers using an incomplete gift approach.

d. GRAT and Gift/GRAT Combo. The GRAT may be the simplest approach. It is an almost riskless solution to the valuation risk because the regulations say that a formula annuity approach works. The retained annuity payments are automatically adjusted if the value of the transferred property is adjusted, thus resulting in no significant additional gift.

If an individual is willing to make a $1 million gift, if the individual just makes a gift a Blackacre (that she thinks is worth $1 million), there is a gift tax risk that the value may ultimately be held to exceed $1 million. If Blackacre is merely contributed to a GRAT, there is no further risk of making any excess gift because of the formula annuity provision, but the client may end up getting back a substantial portion of Blackacre when the trust makes the annuity payments. However, the client's goal of making a $1 million gift and transferring Blackacre in a riskless transaction can be accomplished in a several steps. First, the client could make a gift of $1 million cash to a grantor trust (the "Gift Trust"). Second, the client could contribute Blackacre to a GRAT. When annuity payments are due at the end of years one and two, the GRAT could borrow cash from the Gift Trust. Assuming the cash can be invested to produce income equal to the AFR, there would be enough money to loan to the GRAT so that it could make the required annuity payments in cash. At the end of the GRAT term, Blackacre could pass to the Gift Trust, subject to the loans that it owes to the Gift Trust. (None of the transactions between the Gift Trust and the GRAT are subject to income tax because both are grantor trusts.) The client's goal of making a $1 million gift of Blackacre in a riskless transaction for gift tax purposes is achieved. (If the IRS asserts that Blacacre is worth more than $1 million, the annuity payments would increase, so a portion of Blacacre would have to be distributed back to the donor. Still the donor achieved her goal of transferring as much of Blackacre as possible within her $1 million gift exemption amount, without risking owing gift tax on a gift deemed to be in excess of $1 million.).

Limitations of the GRAT/Gift approach include: (i) inclusion of most of the assets in the estate if the grantor dies during the GRAT term, (ii) probable inability to allocate GST exemption until the end of the GRAT term, and (iii) a built-in discount factor that is almost always higher than the interest rate on a sale for a note.

e. Formula Clause, Especially Defined Value Clause. There are two general types of formula clauses, a fixup clause, and a definition clause.

(1) Fix Up Clause. Under this type of clause, a "fix up" amount is transferred or consideration is paid back to the transferor if the finally determined gift tax value exceeds the intended amount. The IRS has generally won cases involving these clauses. A theoretical problem with the "higher purchase price" format is that there is a speculative element to the additional purchase price on the date of the gift. Due to that speculative element, the additional price feature would not result in a full reduction of the gift value. The only case where taxpayers prevailed with a price adjustment clause was King v. U.S.

(2) Definition Clause Approach. The definition clause works simultaneously, rather than after the gift, to determine the amount of the gift or the amount of the consideration paid for the transfer. If the clause is not honored, there is no way to determine the amount of the transfer.

Consideration Definition Clause. If the defined value clause (that defines the amount being transferred) works, in some cases it could be counterproductive, because it limits the value actually transferred. That is particularly problematic if a rapidly appreciating asset is transferred. It would be better if the formula clause operated not on the property being transferred but on the consideration being received. (That is how a GRAT works.)

Query whether a "consideration definition clause" would work? Under this approach, the trust to which the transfer is being made must be in existence, preferably for some period of time. Also, there must be a separate asset in the trust that can be used to pay the purchase price. For example, assume a client wants to sell Blackacre (that the client thinks is worth 25X) to an existing trust that has cash or marketable securities worth 50X. Before the purchase of Blackacre, the trust could transfer the 50X of cash or marketable securities to a new investment entity, with an operating agreement providing that any member can withdraw any time, so that there would be no entity discounts. The client would sell Blackacre in return for an interest in the new investment entity. The fraction is:

Value of Blackacre as finally determined for gift tax purposes

50X [the known value of the entity].

The full value of Blackacre is transferred in any event. The formula clause would vary what percentage interest in the new investment entity is paid to the client as consideration for the sale. If the finally determined gift tax value of Blackacre is 25X (which is what the client thought Blackacre was worth), the client would receive 25X/50X, or 50% of the new investment entity as consideration for the sale.. If the IRS prevails in saying that the gift tax value of Blackacre is 40X, the client would receive 40X/50X, or 80% of the new investment entity.

Another approach would be for the trust to pay partly with a note and partly with an interest in the new investment entity. For example, in the hypo described above, the trust might pay with a note worth 25X and a fractional interest in the new investment entity. The numerator of the fraction would be the finally determined gift tax value of Blackacre less the value of the note. If the finally determined gift value of Blackacre is 25X, the client would receive the note and no interest in the new investment entity. If the finally determined gift tax value of Blackacre is 40X, the client would receive the 25X note and a (40-25X)/50X, or 30% of the new investment entity.

(For simplicity, the example refers to selling Blackacre. However, the client might prefer to sell just a fractional interest in Blackacre to take advantage of an undivided interest discount.)

This is the first time that I have seen a consideration definition clause being suggested [Carlyn is so creative!!]. Carlyn acknowledges that this approach has not been tested, but she thinks it should work.

f. Do These Definition Clauses Work? These are similar to the formula clauses sanctioned in the §2702, disclaimer, and charitable remainder trust regulations.

The McCord case is the first and only judicial test of a formula definition clause (although the recent Christiansen case discusses a similar formula disclaimer approach, as discussed below.) In McCord, the Tax Court suggested that it might have recognized the clause if it had said "as finally determined for federal gift tax purposes." (The Tax Court did not address the public policy issue.) The Fifth Circuit upheld the formula transfer, but it also did not address public policy concerns. (Marty Basson, an IRS estate and gift tax supervisor in Florida, suggested that perhaps the IRS did not want to take that issue to the Fifth Circuit.) In McCord, the formula value was based upon an arms length determination of value among the donees, who were independent and were represented by separate counsel. The Fifth Circuit did not address the question of whether an acceptable mechanism of determining value would be to use "as finally determined for federal gift tax purposes."

Planners would like for these clauses to be upheld, and the IRS strongly opposes them. The IRS audits less than 1% of gift tax returns, and if the taxpayer can take aggressive positions with no fear of paying more gift taxes or penalties, the IRS fears that abuses would result. (Penalties operate not on the understatement of value, but on the understatement of gift tax attributable to the understatement of value.)

There is still uncertainty after McCord, but taxpayers have more hope that defined value clauses will be sustained by the courts.

After the completion of the Heckerling Institute, a full Tax Court decision addressed the public policy issues of using a formula disclaimer that operates much like a formula defined value clause. The Christiansen case is discussed in more detail in Paragraph l below and is more fully discussed in Item 8 of this summary, below.

g. How to Draft Defined Value Clauses. Carlyn suggests drafting the clause to transfer a fractional portion of specified property, with the fractional portion being described by a defined value formula. She also suggests trying to address the public policy concern that such formulas make gift tax audits meaningless. Tinker with the fraction to build in a little margin for the IRS to have some success if it successfully contests values. Carlyn suggests the following as a possible formula where the client wants to transfer a fractional portion worth $100,000 a specified property:

"I hereby transfer to the trustees of the T Trust a fractional share of the property described in schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $100,000. The denominator of the fraction is the Gift Tax Value of the property."

h. Administering the Gift. Practical problems may arise in administering the transferred property before a final determination of value has been made. One approach to deal with this practical problem is to transfer all of a specified property to a trustee, and to have the formula allocate the property transferred between two different trusts under the trust agreement, one of which would be a completed gift to family (often a grantor trust for family members) and the other of which would be a nontaxable transfer (possibilities include a transfer to a marital deduction trust, a wholly charitable trust, a charitable lead trust, a "zeroed out" GRAT, or a trust that is incomplete for gift tax purposes such as a revocable trust or a trust that gives the donor a retained testamentary power of appointment). As to the outside world, the trustee owns all of the property and clearly can manage all of the property.

To deal with income tax reporting uncertainties, use grantor trusts, so the final determination of ownership does not change who owes the tax on the property. If requirements of the regulations are followed, separate tax returns will not even be required for the separate grantor trusts.

An alternative method of dealing with the practical problems of administering the gift would be to use an escrow arrangement.

i. How to Achieve Finality. Carlyn suggests three methods for determining value.

(1) Determine value directly by an appraiser (but the government can still disagree).

(2) Determine value under a definition described in the agreement, and the parties to the transfer would negotiate on the percentages transferred under that definition. However, with this approach, the only way to avoid a gift tax risk is if the party negotiating the split is a charity. Otherwise, the party negotiating the split has the same gift tax risk that the donor would otherwise have. If a charity is used, there are self-dealing issues, intermediate sanction issues, and the possibility that the Attorney General will become involved in the negotiations.

(3) Use values as finally determined for federal gift tax purposes. Section 2001(f) says that final value is the value listed on the gift tax return if there is adequate disclosure, or the value specified by the IRS, or the value determined by court, or the value determined by settlement. In any event, a gift tax return must be filed and there must be adequate disclosure.

j. Incomplete Gift Approach. Again, Carlyn hastens to add that this technique is not tested, but it should work in situations where the client wishes to make a sale rather than a gift.

Example. The client (W) is married and wishes to sell property to a trust previously created for her and her children by H. Under the terms of that trust, W has a power of appointment exercisable over the property in favor of her issue. The trust has at least $200,000 (enough to support a sale for a $1.0 million note). W sells an asset to the trust that she thinks is worth $1.0 million for a $1.0 million note. The transaction is reported on a gift tax return as a non-gift completed transfer (under Reg. §301.6501(c)-1(f)(4)). If the IRS challenges the valuation and the value is determined really to be $1.5 million, the client will not owe gift taxes. W is treated as a transferor to the trust as to the excess value over the note that she received; but that is an "incomplete gift" for gift tax purposes because of the power of appointment. Once it has been determined that the transfer exceeds the value of the note, it would be helpful to split the trust, so she could make more gifts to the completed gift portion, and the trustee could make distributions from the completed gift portion without making an additional gift. (Splitting the trust should be possible if the trust agreement allows the trustee to divide the trust into separate trusts whenever anyone makes a gift to the trust so that assets gifted by each donor are held in separate trusts.)

The trust is not a grantor trust as to W but it is as to H. Section 1041 says that if one spouse sells to the other, it is treated as a gift for income tax purpose — so there is no income recognition. (If W were to sell assets to a trust created by her father, the sale to the trust would generate taxable gain.)

k. Combining Consideration Definition Clause and Incomplete Gift Trust Approach. If the client wants to assure that she is transferring all of a specified asset, the consideration definition clause approach could be combined with the incomplete gift trust approach.

Example. W wishes to sell Blackacre (which she thinks is worth \$1.0 million) to a trust previously created for her and her children by H. W has a power of appointment under that trust in favor of her issue. That trust has \$200,000 of cash or marketable securities. The trust transfers the \$200,000 of assets and a \$1.8 million note to an LLC that has no withdrawal restrictions and that is designed to eliminate any entity discounts. Therefore, the trust's interest in the LLC is worth \$2.0 million. W sells Blackacre to the trust in return for a fractional interest in the LLC. The fractional interest is:

$$\frac{\text{Greater of \$1.0 million or the value of Blackacre as finally determined for federal gift tax purposes}}{\text{\$2.0 million}}$$

If the finally determined value of Blackacre is \$1 million, W will own \$1.0 million/\$2.0 million, or 50% of the LLC. If the finally determined value is \$1.5 million, W will own \$1.5 million/\$2.0 million, or 75% of the LLC. In either case, W will have transferred the full interest in Blackacre without incurring gift tax risk (assuming courts ultimately recognize these types of clauses). Even if the IRS and the courts do not recognize the validity of the consideration definition clause to avoid gift treatment, any deemed gift will be made to an incomplete gift trust (because of W's power of appointment over the trust), so will not generate gift tax.

l. Tax Court Address of Public Policy Concerns in Christiansen; Formula Disclaimer With Excess Over Specified Amount Passing to Charity. In Estate of Christiansen v. Commissioner, 130 T.C. No. 1 (2008), the decedent's daughter made a formula disclaimer that in effect disclaimed a fractional share of the estate exceeding \$6.35 million (with the fractional formula being stated in terms of values as finally determined for federal estate tax purposes). Some of the disclaimed assets passed directly to a foundation, and as to those assets, the only issue was whether the formula disclaimer should be invalidated as a condition subsequent or as violating public policy. Every judge participating in this Tax Court case rejected those arguments and upheld the formula disclaimer.

As to the last two of the concerns mentioned in Procter, that the clause renders a court's decision moot and that the clause would upset a final judgment, the court responded:

"This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in Procter about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the Court acknowledged that IRS's incentive "will marginally decrease," but observed that lurking behind the Commissioner's argument is the intimation that this type of arrangement will increase the possibility that an estate will lowball the reported value of the estate to cheat charities. However, the majority reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets.

The court's reasoning does not seem to address directly the "discourage collection of tax" argument, and seems overly simplistic in stating that the arrangement will only "marginally decrease" the IRS's incentive to audit returns. (There are a wide variety of planning strategies that can reduce the IRS's incentive to audit returns — such as the common formula marital deduction clause in a will, and a broader discussion of this public policy concern would have been more helpful.) However, every Tax Court judge participating in the opinion either joined in the majority or concurred in the public policy aspect of the decision. (Judges Chiechi, Gale, and Laro did not join in any of the opinions, and Judge Halpern did not participate in the case.)

The court's reasoning, which emphasizes outside policing mechanisms, applies where the "pourover" transfer is to charity, but does not apply as strongly where the pourover is to a family entity. The trustee fiduciary duties would be present, but the references to fiduciary duties of directors of a foundation, to state attorneys general, and to the Commissioner (in overseeing charitable entities) would not apply.

The Tax Court unanimously upheld on public policy grounds formula disclaimers that operate much like defined value transfers, without saying in that analysis that it was relying to any degree on the fact that formula disclaimers are specifically authorized by regulations. This might suggest that the Tax Court would rule similarly when faced with whether defined value transfer clauses violate public policy. It is interesting that in McCord, the Tax Court seemed to stretch to find a way of avoiding having to address the public policy effect of a defined value clause, but the Tax Court in Christiansen unanimously found no public policy concerns with a similar approach using a formula disclaimer (at least where the disclaimed assets passed to charity).

See Item 4 of this summary for a more detailed discussion of this case.

m. Other Pending Case. John Porter indicated that another case is pending addressing the gift of a specific dollar amount is finally determined for federal gift tax purposes, with the excess over that amount passing to charity. That case is Petter v. Commissioner.

n. Comments of Marty Basson About Defined Value Clauses. Marty Basson said that the IRS national office feels very strongly about defined value clauses. He suggested that perhaps the national office did not argue the public policy issue in McCord, cause it did not want to go to the Fifth Circuit on that issue. "If there is one issue the national office feels strongly about, it is the public policy issue. You may see this in court, but we want the opportunity to challenge your position. We do not want to give that up. At the field level, we will argue these cases."

o. Analogy to Buy Sell Agreements. The IRS may argue that the price in a buy-sell agreement is not effective for estate tax purposes, and take the position that the estate tax value is much higher even though the estate is stuck with selling the stock at the lower price under the agreement. It might be possible to use a clause in the agreement saying to increase the price under the agreement if the IRS does not accept the buy-sell agreement value. However: (1) Will the parties be willing to do that; it is a huge risk for whoever the purchaser might be under the agreement; and (2) Is that at all suggestive that the buy-sell agreement might be a device under §2703(b) that is not recognized for estate tax purposes? If the IRS argues that the existence of the clause designed to save the day is itself the very reason that §2703(b) applies, "instead of saving your bacon, it cooks your bacon."

5. **Formula Disclaimer With Excess Over Specified Amount Passing to Charity, Estate of Christiansen**

The Tax Court reviewed the validity of a formula disclaimer, that operated much in the same manner as defined values clauses, in <u>Estate of Christiansen v. Commissioner,</u> 130 T.C. No. 1 (2008). The court unanimously approved the formula disclaimer to a foundation and rejected the IRS's arguments that the clause violated public policy (and much of the court's reasoning would also apply to defined value clauses — the court did not rely on the fact that formula disclaimers are specifically authorized by the regulations in its public policy discussion). (While all of the judges in this full Tax Court opinion agreed as to the validity of the formula disclaimer for assets passing to the foundation, the opinion itself says that Judge Halpern did not participate in the opinion, and Judges Chiechi, Gale, and Laro did not join in any of the majority, concurring or dissenting opinions.)

a. <u>Formula Disclaimer With Assets Passing to CLAT and Foundation</u>. The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a charitable lead annuity trust and 25% to a foundation. (The charitable lead trust paid an annuity to charity for 20 years equal to 7% of the initial value of the trust. Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of $6.51 million. The specific formula disclaimer clause provided, in part, as follows:

"Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…"

In addition, the disclaimer included a "savings clause" which provided that to

"the extent that the disclaimer set forth above in this instrument is not effective to make it a qualified disclaimer, Christine Christiansen Hamilton hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. (As mentioned below, the IRS agreed that it would allow a charitable deduction for the $40,000 that passed to the foundation as a result of the disclaimer — based on the values reported on the estate tax return.)

In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. (The estate included farm and ranching businesses that had been transferred to family limited partnerships. Apparently, a settlement was reached that reduced the claimed discounts and also settled a §2036 claim by the IRS. Under the disclaimer, the additional $3.1 (i.e., $9.6 – 6.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount transferred so that there would be no (or minimal) additional gift tax over the anticipated amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

b. Effectiveness of Disclaimer to CLAT. The majority held that the disclaimer was not a qualified disclaimer as to the 75% potion that passed to the CLAT, because the disclaimed property did not meet the requirement in §2518(b)(4)(B) of passing "to any person other than the person making the disclaimer." (Accordingly, no estate tax charitable deduction was available for the 75% that passed to the CLAT.) The majority reasoned that the daughter retained her contingent remainder interest, which was not "severable property" or "an undivided portion of… property." Therefore, no portion of the disclaimer to the CLAT was a qualified disclaimer.

Regulation §25.2518-2(e)(3) includes the following statement:

"If the portion of the disclaimed interest in property which the disclaimant has a right to receive is not severable property or an undivided portion of the property, then the disclaimer is not a qualified disclaimer with respect to any portion of the property. Thus, for example, if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed."

The example in that regulation seems to apply specifically to a CLAT remainder, but the example is prefaced with the prior sentence saying that the section applies if the disclaimed property is not severable property or an undivided portion of property.

The terms "severable property" and "undivided portion of the property" are described in Regulation §25.2518-3(a)(1)(ii) and §25.2518-3(b), respectively. The "undivided portion" regulation includes the following statement:

"A disclaimer of some specific rights while retaining other rights with respect to an interest in the property is not a qualified disclaimer of an undivided portion of the disclaimant's interest in property. Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimer disclaims a remainder interest in Blackacre, but retains a life estate."

The majority reasoned that the contingent remainder interest fell within this example, with a wonderful analogy to a piece of meringue pie [if there's anything I understand, it is coconut meringue pie!]:

"Disclaiming a vertical slice — from meringue to crust — qualifies; disclaiming a horizontal slice — taking all the meringue, but leaving the crust — does not."

(Two dissenting judges disagreed, reasoning in part that a disclaimant can make a qualified disclaimer of income if the decedent herself carved out income or corpus interest in her will, and a disclaimant is not trying to do so through the disclaimer. They argue that the *decedent* created the CLUT that received the disclaimed interest, and that the disclaimant did not create the charitable lead interest and the remainder interest. In addition, they argue that the disclaimant's remainder interest and the foundation's lead annuity interest in the CLU are complete and independent of each other and therefore meet the definition of severable property. The charity has the right to receive specified fixed annuity payments over the 20 year term of the trust, and — unlike an income interest — does not vary based on what happens to the rest of the trust. A concurring opinion responds that the annuity and remainder are even more dependent on each other than an income and remainder interest, because some of the annuity interest might have to be paid from principal, which would reduce the value of the remainder.)

[Observation: I do not know of any cases that have previously addressed specifically whether disclaimed assets can pass to a CLAT in which the disclaimant has a remainder interest. In PLR 9501036, the IRS ruled that a disclaimer, which resulted in assets passing to a CLAT, was a qualified disclaimer where the disclaimant also disclaimed the remainder interest in the CLAT. The ruling did not specifically say that the additional disclaimer of the remainder interest was essential to the validity of the disclaimer to the CLAT. Also of interest is PLR 9610005, which ruled that a unitrust interest in a CRUT is separate from a disclaimed principal interest, even though unitrust payment would be made from principal if income was insufficient.]

<u>Effect of Disclaimer Saving Clause</u>. The majority also concluded that the disclaimer "savings clause" did not save the day. The majority said it did not have to determine whether this kind of savings clause violates public policy. It reasoned that if the savings clause operates once the court enters a decision, the resulting disclaimer will have been made more than nine months after the decedent's death. If the savings clause is "read as somehow meaning" that she disclaimed the contingent reminder back when she signed the disclaimer,

"it fails for not identifying the property being disclaimed and not doing so unqualifiedly, see sec. 2518(b), because its effect depends on our decision. Such contingent clauses — contingent because they depend for their effectiveness on a condition subsequent — are as ineffective as disclaimers as they are for revocable spousal interests [citing <u>Focardi</u>] and gift adjustment agreements [citing <u>Ward</u>]."

That language in the majority agreement casts doubt on savings clauses that are interpreted as depending upon a condition subsequent and particularly on disclaimer savings clauses.

c. <u>Effectiveness of Formula Disclaimer to Foundation</u>. The 25% of the disclaimed assets that passed directly to the foundation had no problem satisfying the "pass to someone other than the disclaimant" requirement. The Commissioner challenged the formula disclaimer to the foundation for two reasons: (1) any increasing amount passing to the foundation was contingent on a condition subsequent; and (2) the disclaimer's adjustment phrase (based on "value [as] finally determined for federal estate tax purposes") is void as contrary to public policy.

(1) Condition subsequent. The IRS pointed to regulation §20.2055-2(b)(1) which disallows a charitable deduction if

"as of the date of legacy to his death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective…"

The court concluded that regulation does not apply because the regulation refers to "a transfer" of property passing to charity, and the *transfer* to the foundation in this case occurred at the time of the disclaimer and is not contingent on any event that occurred after the decedent's death. "That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent…"

(2) Public policy concerns. The most interesting aspect of the opinion is its analysis of the public policy concerns. The court said it was hard pressed to find any fundamental public policy against making gifts to charity. Nevertheless, the Commissioner cited the Procter case, which addressed a clause specifying that a gift would be deemed to revert to the donor or if it were held to be subject to gift tax. The Fourth Circuit in Procter voided the clause as contrary to public opinion, citing three reasons: (1) the provision would discourage collection of tax, (2) it would render the court's own decision moot by undoing the gift being analyzed, and (3) it would upset the final judgment. As to reasons (2) and (3), the court's reasoning seems to apply to defined value clauses generally:

"This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in Procter about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the court acknowledged that the IRS's incentive "will marginally decrease," but observed that lurking behind the Commissioner's argument is the intimation that this type of arrangement will increase the possibility that an estate will lowball the reported value of the estate to cheat charities. However, the majority reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets (by threatening to rescind the charity's tax exemption or by its power to impose intermediate sanctions).

The court's reasoning does not seem to address directly the "discourage collection of tax" argument, and seems overly simplistic in stating that the arrangement will only "marginally decrease" the IRS's incentive to audit returns. (There are a wide variety of planning strategies that can reduce the IRS's incentive to audit returns — such as the common formula marital deduction clause in a will, and a broader discussion of this public policy concern would have been more helpful.) However, every Tax Court judge participating in the opinion either joined in the majority or concurred in the public policy aspect of the decision. (As mentioned above, Judges Chiechi, Gale, and Laro did not join in any of the opinions, and Judge Halpern did not participate in the case.)

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6. What's Going On Within The IRS?

Aileen F. Condon is the Chief, Estate and Gift Tax Program with national program responsibility for estate and gift tax field operations policy. She addressed various issues about IRS structure and focus issues in handling audits.

a. Restructure and Reductions. Attorneys have recognized structural changes, as they often are having audits conducted by agents in another part of the country. In October 2004, the IRS reorganized Estate and Gift so that was no longer in five different Divisions. Goals include:

- Fair and consistent treatment of taxpayers.
- Engaged workforce with input to emerging issues (including the need for published guidance and input on Forms).
- Effective operations in identifying workload and conducting audits.
- Increased compliance and enforcement presence.

There was a staff reduction, which Aileen believes was the right decision based on the reduction in filings in the estate tax area. The IRS has done an extensive study and projects that they are maintaining an audit level consistent with prior years, even with the reduced staff. There are now 275 field examining estate and gift tax attorneys.

b. Examination Process. The goal is for the IRS to review the most audit worthy cases. All estate and gift tax returns are initially reviewed in Florence, Kentucky. Aileen's group identifies audit cases, but Field has discretion of whether to audit those as well.

Estate and Gift now views its workload as a national workload. Estate tax attorneys are not present in all locations in the same percentage as filings. (They would like to have agents located proportionate with filings, but they aren't.) So there is certainly the possibility of a California estate being audited out of New York.

John Porter says this is not that difficult to deal with. There are few face to face meetings anyway. John typically travels to where the agent is — the case moves quicker that way. In any event, with the ability to communicate long distance, it has not been difficult.

Aileen said that the IRS is not hesitating to travel as needed to conduct interviews, get information, have discussions, etc.

Estate and Gift has developed "designated state law experts" to provide helpful information about the relevant state law issues.

Marty Basson has been doing audits around the countries for years — because Florida estates are often handled by attorneys in other parts of the country (particularly New York).

John Porter said that the same thing is happening in Appeals; Appeals Officers from other parts of the country often hear cases.

c. How Examinations Are Conducted. IRS agents are urged to set mutual commitment schedules, with an outline of mutual expectations, the nature of requests, the timeframe for taxpayer responses, and the timeframe for the IRS agent to respond. Aileen expects that upfront dialogue to occur in all estate and gift audits.

IRS surveys of customer satisfaction show that the IRS has the "opportunity to improve" in the areas of timeliness and time span of the audit. The IRS gets good marks for technical determination, courtesy, etc.

If attorneys are having problems with an agent in the audit process, do not hesitate to pick up the phone and discuss problems. Also, don't hesitate to pick up the phone and call the manager who might be able to facilitate the process for both. Do not just wait until the end of the exam for a manager conference. (The IRS does not have as many managers and they may not be in the same location as the agent, but "we will make it work.")

d. Communication with Taxpayers. The IRS reminded IRS attorneys recently to communicate directly with taxpayers — even if there is a power of attorney for authorized representatives. The IRS will copy the authorized representative on everything sent to the taxpayer. It is possible for the taxpayer to waive receiving correspondence directly. Some attorneys have questioned if that is appropriate; the IRS thinks it is based on Reg. §601.506.

e. eStrategy. Aileen indicated that the IRS does not have an eStrategy but it needs one. For example, a field agent will not want to accept a compact disc containing voluminous records instead of a huge stack of paper, for fear that the compact disc will not stay with the return. "We are a bit behind the times and trying to get on track. It is an issue of funding as well."

7. Hot Topics Comments by IRS Supervisors

Aileen F. Condon (Chief, Estate and Gift Tax Program with national program responsibility for Estate and Gift tax field operations policy) and Marty Basson (Supervisory Attorney, Estate and Gift Taxes for South Florida Territory) addressed several "hot topics" issues (some of which are covered in other Items of this summary).

a. Section 6166 Lien Agreements. Aileen Condon said the IRS has been looking at the lien procedures process for many months, even before Roski (which held that the IRS could not, in its IRS Manual, require a lien in every §6166 deferral case). If the taxpayer believes that it should not have to provide a lien in a particular case, the IRS will consider the factors in Notice 2007-46, but Aileen pointed out that we may see changes in the procedures. Collection Advisory will be taking more of a role in securing lien agreements under §6166.

b. Penalties. Is there going to be more emphasis in asserting penalties? There has been no more guidance issued on when to assert penalties; each case is independent. There are no quotas. If appropriate, penalties will be asserted. The heads of IRS Appeals, and IRS Counsel have indicated that when agents believe a penalty is applicable, they are not trade and swap issues in the audit.

c. Appraiser Penalties. The IRS has not issued guidance to agents or to the public regarding the new appraiser penalties. Regulations will be coming out at some point.

d. Preparer Penalties. Aileen said that she does not know why estate and gift tax has been left out of the preparer penalty provisions in the past, but she thinks it is appropriate to include them. The IRS has issued Notices 2008-11, -12, and -13. Regulations are in development.

e. FLP Issues. See Item 1(h) of this summary.

f. Defined Value Clauses. See Item 4(n) of this summary.

g. Near Taxable and Nontaxable Gifts. How much compliance (or noncompliance) is there? "We have a suspicion but do not know."

h. Built-In Gains Discount, Jelke. Marty Basson agrees with the dissent in Jelke. It basically said that the majority was just lazy. So Marty refers to Jelke as the "Lazy Man's Case."

i. Graegin Loans. Where there was a fixed interest rate and a huge prepayment penalty, the Graegin case allowed a full upfront administrative expense deduction for the total calculated amount of interest that will ultimately be paid. John Porter indicates that he has seen Graegin loans used often, and they yield a huge present value timing benefit. The IRS has scrutinized Graegin loans and issued a TAM refusing to allow an interest deduction where (i) most of a decedent's estate was contributed to an FLP before death, (ii) the partners of the FLP and beneficiaries were almost exactly the same, (iii) the executor was a general partner, and (iv) there was no reason for needing to keep the funds in the partnership to carry out the purposes of the partnership.

8. Feeling Pressure to Accommodate Client Regarding Return Positions or Taking Other Questionable Positions

Dennis Belcher: "Don't let your client's money be your money. Corollary: It's only money — and it's somebody else's."

Carol Harrington: "We are in a service business and like to be service oriented and accommodating to clients. But forget that when filing returns. I don't go to jail for anybody. Don't let clients push you around on return issues. It's just nonnegotiable."