SAN ANTONIO ESTATE PLANNERS COUNCIL

SAN ANTONIO, TX
APRIL 21, 2015

What We Have Learned from Litigating Family Limited Partnerships

Presented By

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I. Initiation of the Examination.

A. Opening letter will normally come fairly quickly after filing the Form 706; usually at about the one year mark.

B. Prior to sending the opening letter, the agent will have spent some time with the return, doing some preliminary analysis on likely issues. The opening letter may:

1. Ask for explanations of those items in general terms;

2. Have a laundry list of items to be produced; or

3. Just notify you of the return's selection, and then be followed by a massive IDR.

II. The Initial Information Document Request (IDR)

A. It may be massive.

B. Why is it so big?

1. Perhaps it is just to expeditiously start the process by getting all, or most, of the relevant documents to the agent in a timely manner.

2. Certainly there is an element of intimidation to these requests.

3. I suggest that, in at least some cases, these requests are a set up to an argument that Section 7491 will not be applicable.

a. What's Section 7491? It is an odd Taxpayer-Bill-of-Rights provision that says that if certain conditions are met then the burden of proof shifts to the government in subsequent litigation. Net worth and income limitations render it functionally useless for most tax controversies.

b. So why is it important? Because the limiting language omits estates, so it applies to all estate tax exams. Critically, the government is very nervous about burden of proof issues: because they win a lot of cases using it and because most government attorneys are uncomfortable shouldering the burden. So the threat of a burden shift becomes an important pretrial bargaining chip.

c. How does the massive IDR undercut an estate's chance of using Section 7491? For that section to apply the estate must have reasonably cooperated during the examination process. *See Section 7491(a)(2)(B)*.

d. So the government issues a massive IDR hoping the estate will not comply, and therefore not have reasonably cooperated, taking Section 7491 off the table.

e. Paranoid? Perhaps, but typically an unanswered IDR leads to a summons and to my knowledge none of these have gone that route.

C. How do you respond?

1. I think you make a good faith effort to respond in a timely manner. Arguably you are required to do so under Circular 230.

2. I would negotiate the response date and, where appropriate, the breadth of the summons. For example, you may be able to work out production in more manageable stages.

3. Note that these IDR's often call for you to produce explanations or responses; this is worrisome.

a. Technically, you are not required to "create" anything for the IRS, so you can object to these requests.

b. Be wary that you may be violating evidentiary privileges by responding; and once breached those are gone forever.

c. If you do respond you may be inadvertently saying the wrong thing, and once a written answer is enunciated it is very difficult to retract.

4. This would be a very good time to consider hiring an attorney.

5. However, you respond and keep good records to show what you gave the agent and when. This may become important later on.

III. The Audit.

A. Do not be surprised if after the initial IDR and response you do not hear from the auditors for an extended period. There are relatively few (about 220) transfer tax agents nationwide, and so they are both busy and understaffed.

1. I suggest that at regular intervals you write a letter asking if additional information is necessary, for an update on how the audit is progressing and request an expected closing date for the examination.

2. No matter how long the silence, not how hopeful your client may be, the case is not misplaced or forgotten.

3. A pattern of a burst of activity, followed by silence, is typical.

B. Changes in personnel. Because estate tax auditors are overage they sometimes simply retire in the middle of an examination.

1. If this happens, there is no notification. Typically, a period of silence ends with the appearance of another agent.

2. Our universal experience is that this leads to a curtailed, hurried, audit with little issue development.

C. Out of Area Personnel. In order to make up for local agent shortages, the IRS has begun to farm out 706 audits to out-of-state offices.

1. This makes very little sense because the out of state agents are unfamiliar with local law that is important in estate tax cases, like oil and gas rules and community property.

2. The problem is made worse because the agents are not given funds to travel, so everything must be handled by correspondence.

3. Again, our experience is that these audits produce thin reports with few developed issues; although they do produce more penalties, perhaps caused by the auditor’s frustration.

D. Appraisers.

1. It is very important to monitor the agent's appraiser throughout the audit. Most government appraisers have a set agenda, which surprisingly does not include interviews of critical personnel or site visits. If the appraiser does these things you want to be present to observe, but normally they don't. This makes them extraordinarily vulnerable to cross examination later on.

2. The type of appraiser hired will tell you a lot about the agent's (or his manager's) appraisal of the case.

a. No appraiser indicates either a small case or one which the government thinks will not go far in the system.

b. No appraiser could also mean that the agent lacks funds to hire an outside expert, which is a very real possibility.

c. Use of an IRS engineer.

(1) Some IRS engineers are very good, especially in the oil and gas area.

(2) By definition IRS engineers lack independence, which is a basic requirement of a testifying expert, so it is doubtful he will make it that far in the system.

(3) This could be an indicator that the IRS does not intend to take the case to trial, or that they simply lack funds to hire an outside appraiser.

d. An outside appraiser indicates the IRS is seriously pursuing the case.

3. Can the IRS change or replace an appraiser?

a. This is possible, but unheard of during the examination.

b. It occasionally happens as trial approaches, but is still rare. Any new appraiser is bound to arrive at a different number (or risk looking very unprofessional)--if it is "higher" then, the government has to take the burden of proof on the marginal difference, and if "lower" has to concede a portion of the case. More fundamentally, IRS counsel appears to avoid changing experts because:

(1) The existing expert was chosen by others, and therefore the attorney does not accept blame for any shortcomings.

(2) The case, especially in Tax Court, comes to the attorney too late to make a change.

(3) Money may not be available to replace.

c. As a result, many government cases proceed through the system with defective reports.

4. So what do you do if you recognize the government's expert has made a mistake in the report?

a. This is a strategic decision to which there is no automatic answer.

b. Under almost all circumstances I would advise against pointing out the error; to do so will simply allow the government to correct its report.

c. I would wait until you believe settlement of the case is possible and then pull out the error. This may be in exam, but probably occurs in appeals, and possibly only as trial nears. A material error in the government’s expert report is very significant, and may produce a spectacular result for your client.

d. I would not wait until trial in the Tax Court to unveil the error; a judge might see this as gamesmanship and/or a waste of judicial resources. In refund litigation, experts will have been deposed and the error illuminated, so the issue does not arise.

5. The government seldom hires multiple appraisers.

a. Many FLP's involve two layers of discounts; one on the contributed asset and another on the fractional equity interest being transferred. This means you will almost certainly have to hire two experts.

b. For some unknown reason, perhaps economy, the government seldom hires two experts; meaning they functionally abandon one of the layers of discounts.

c. They will always opt for the entity level appraiser; meaning the asset values will probably go unchallenged.

E. What if the auditor gets into a time crunch?

1. Ever so often an overworked auditor simply waits too long to work a case; or perhaps is delayed in moving forward waiting for others (valuation experts) to complete their work.

2. Remember that the statute of limitations on assessment can not be extended for estate taxes, *see Section 6501(c)(4)(A),* so the usual out of statute extensions is not available.

3. As the three-year period for assessment begins to wind down, internal IRS rules begin to kick in, meaning an agent intent on making adjustments has to release the case to allow for preparation of the Statutory Notice of Deficiency. Normally, these require the agent to hand off the case at least 60 days before the statute runs. So the agent's true deadline is earlier than it appears.

IV. Pre-docket Appeals.

Practically this option seldom exists because most agents will use so much time in producing the Statutory Notice of Deficiency, and insufficient time remains to allow an appeal. If you have one of the rare cases where this does exist, take the appeal. Appellate Division is a relatively inexpensive and sometimes effective way to achieve a settlement, and attempting it has virtually no downside.