



Current And Anticipated Trends in Transfer Tax Litigation

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IRS Administration

- “The most serious problem facing U.S. Taxpayers is the declining quality of service provided to them by the IRS when they seek to comply with their federal tax filing and payment obligations. The deficiencies in taxpayer service have been on our “Most Serious Problems” list for several years.”

Nina Olson, National Taxpayer Advocate

IRS Administration

It's easy to list the problems besetting the Agency:

1. Money. In inflation, adjusted funds in the IRS budget have fallen from \$10.236 billion in FY 2005 to a projected \$8.984 billion in FY 2015. Both congressional allocations and administration budgets have been below agency requests.
2. Workload. Returns: During the same period, total returns have increased from 143 million to a projected 161 million.

IRS Administration

Problems:

1. Personnel. Since FY 2010, the number of full-time-equivalent employees has fallen by 12.3%, to a FY 2014 low of 82,982. By comparison, in the mid 1990's the IRS total personnel reached 140,000, including seasonal workers.
 2. Training Dollars. Training dollars per full-time-equivalent employees has failed from \$1,774 in FY 2010 to \$339 in FY 2014. This is actually an improvement over the FY 2013 amount of \$240.
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IRS Administration

The results of these problems are easy to document:

1. Phone access.

Approximately 100 million Taxpayers call the IRS each year. In FY 2015 the IRS is projected to answer 50% of these calls, with a wait time of about 30 minutes. By comparison, in FY 2004 the IRS answered 87% of calls after 2 ½ minutes on hold.

Qualitatively, the IRS now only responds to “basic tax questions”, so they have dumbed down their telephone services.

Practitioner Priority Service (PPS) designed for Enrolled Agents, CPA's and Attorneys “...has become an object of derision among practitioners...” with wait times averaging 41 minutes. Report to Congress, at 5.

Unanswered calls are given a “courtesy disconnect”; a bureaucratic term for a hanging up.

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5

IRS Administration

The results of these problems are easy to document:

2. Correspondence.

Approximately 10 million Taxpayers attempt to correspond with the IRS each year. The guidelines are supposed to process these within 45 days. In FY 2005, the IRS failed to do this in 2% of the letters; in FY 2014 that had risen to 51%; a 2450% increase.

3. Walk-in Assistance.

Walk-in sites are called Taxpayer Assistance Centers (TAC) and are very important to low income, elderly, disabled and taxpayers with limited English proficiency.

- They have reduced the number of TAC's and skeletonized staff.
- Only respond to “basic” tax questions during filing season and declined to answer any questions afterwards (questions answered went down 86% from FY 2004 to 2013).
- The IRS has halted its practice of preparing returns for low income, elderly and disabled taxpayers completely.

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6

IRS Administration

Some of the IRS problems are self-created:

1. Rehiring problem employees:

From January 2010 to September 2013, the IRS rehired about 7,000 former employees.

“TIGTA found that nearly 20% of the rehired former employees sampled have prior substantiated or unresolved conduct or performance issues...”
TIGTA Semiannual Report to Congress, March 31, 2015 page 12.

They sampled 300 rehires at random and found that 141 had prior substantiated tax issues, including 5 who had failed to file tax returns.

In a noteworthy understatement, IRS officials indicated that prior conduct and performance issues did not play a significant role in their decision to rehire.

IRS Administration

Self-created problems:

1. Appeals.

One of the IRS' success stories is Appeals, who settle a substantial number of tax controversies without litigation. The Service rewards this success by closing down Appellate Offices and reducing officers.

Almost ¼ of all states have no permanent Appeals presence, with a significant portion of the closings occurring since FY 2011.

The IRS has substituted “circuit riding” officers. This tactic expands the time in appeals by about 6 months and significantly reduces the level of agreement, when compared to face-to-face meetings. The number of case closing for circuit riders has fallen by about ½ since FY 2011.

The number of Appellate Officers has decreased by 27% from FY 2010 to FY 2014.

President Trump's Proposal

- Repeal the Estate Tax
- Impose a 20% capital gains tax on property held at death and valued at more than \$10 million. This would include exclusions for small businesses and family farms. Presumably, the dollar limitation is per couple. No definitions yet on either small businesses or family farms. It is also not crystal clear whether the capital gains tax could be delayed until the asset is sold.
- The proposal also limits or disallows contributions of appreciated assets to a private charity established by the decedent or the decedent's family.
- No repeal of Gift Tax, maybe.

How About Stepped Up Basis for Assets
Below \$10 Million?

Proposed Regulations for Valuation Under Section 2704

If You Can't Beat Them – ~~Join Them~~

Change the Rules

Issues Identified By Treasury & IRS

- Proposed regulations treat transfers occurring within 3 years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of 2704(a).
- Current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments.
 1. Dissolution vs. Redemption. Courts have concluded that, under the current regulations, 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity.

Issues Identified By Treasury & IRS

2. State Law Exception. The current regulations except from the definition of an applicable restriction - a restriction on liquidation that is no more restrictive than that of the state law that would apply in the absence of the restriction.
3. Assignee Interests. Taxpayers have attempted to avoid the application of 2704(b) through the transfer of a partnership interest to an assignee rather than to a partner.
4. Nominal Interests. Taxpayers have avoided the application of 2704(b) through the transfer of a nominal partnership interest to a non family member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction.

Amendments

- Regulations Are Amended:
 - Define Control – To address what constitutes control of an LLC or other entity that is not a corporation or partnership (amend 25.2701-2);
 - 3 Year Rule – To address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest (amend 25.2704-1);
 - Narrow “Applicable Restriction” – To refine the definition of the term “applicable restriction” by eliminating the comparison to the liquidation limitations of state law (amend 25.2704-2);
 - Add New “Disregarded Restriction” – To add a new section to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interest held by persons who are not members of the family (add 25.2704-3).

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Where is the Government on the Section 2704 Regulations?

- As of late January, they were moving forward with the regulations.
- As of that date, the IRS had received “in excess of 10,000 comments.” I am certain a few positive.
- The public hearing in December 2016 was the “longest hearing in recent memory” and went on for more than 6 hours.
- They generated “significant controversy” according to IRS spokesperson.

The AICPA urged the IRS to withdraw the Section 2704 regulations on January 18th of this year.

Acknowledged Problems with the Regulations:

- The “deathbed transfer rule” using a 3 year time period has been under heavy scrutiny; some indications are that the IRS may soften its stance to 1 year.
- The rules surrounding the “local law exception” appear to be crumbling. Catherine Hughes, attorney-adviser, Treasury Office of Tax Legislative Counsel speaking in late January said:

“I will tell you that I think we made a mistake in drafting the regulations. We need to substitute another threshold for that, and we will think about that as we work on the final regulations.”
- The proposed “disregarded restrictions” were drafted too broadly. The IRS acknowledges that they do not distinguish between operating businesses and other entities; not between “cooperating” and “dysfunctional” families.
- The whole concept of “disregarded restrictions” is causing problems –the IRS is reduced to a hair splitting distinction that appraisers should “pretend it doesn’t exist” but not assume that the affirmative assumption does exist. Ponder this. The IRS promises to make it clear in the final regulations.

Trust Us

The IRS reassures us that the “proposed regs don’t eliminate minority discounts, and we will make that very clear in the final regulations...”

The House Ways and Means Committee Chairman (Kevin Brady; R-Texas) has asked the IRS to pull the regs.

Lots of Work for Estate Planners, Less So For Litigators

- Consider for a moment that if some version of the Trump plan is enacted it will instantly make almost all large estate plans obsolete.
- It will shift the emphasis on tax planning to income taxes.
- If the proposed 2704 regulations are held up or modified then valuation issues would still be very important; although lower marginal rates and the non-deductibility of administrative expenses would change the economics of litigation.

Moral within the IRS

- Serious campaign talk about abolishing the IRS is taken quite seriously within the Service.
- The “Targeting Scandal” has embarrassed and troubled many senior agents who took pride in their work.
- Republican intent to abolish the Estate Tax
 - relative few agents,
 - many are nearing retirement,
 - little opportunity for agents to transfer to other work (remember prior firings with Estate and Gift).

Moral within the IRS

- How is this Affecting State and Gift Cases in the system?
 - agents are retiring or leaving mid-audit;
 - pervasive lack of initiative;
 - slow progress on cases;
 - offers to settle being made without adequate investigation.

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Mr. Cousins is Board Certified in Tax Law by the Texas Board of Legal Specialization. His practice focuses on Income Tax Litigation, Estate and Gift Tax Litigation, and White Collar and Government Regulatory Litigation. He represents corporations and individuals in tax controversies, both administratively and in litigation. In addition, he has defended taxpayers in criminal tax matters.

In recent years much of his practice has involved Estate and Gift Tax litigation and he has tried numerous cases in that area, including: *Estate of Knight v. Commissioner*, *Jones v. Commissioner*, *Estate of Foy Proctor v. Commissioner*, *Estate of Fleming v. Commissioner*, *Estate of Marmaduke v. Commissioner*, *Adams v. United States*, *Kimbell v. United States*, *Keller v. United States*, and *Marshall v. United States*. He successfully argued the Fifth Circuit of Appeals in *Adams*, *Kimball*, *Keller* and *Marshall*.

Trey has broad experience in the civil tax arena, trying excise tax cases (*Moody v. Commissioner*), bankruptcy cases (*In Re: Hutton*), refund cases (*Advertisers Dynamic Services Co., Inc. v. United States*), as well as substantive tax cases (*70 Acre Recognition Partners v. Commissioner*, *Pediatric Surgeons v. Commissioner*, etc.).

Trey is a Certified Public Accountant and an active speaker on substantive and procedural tax issues for numerous professional organizations nationally. He has been named a Texas Super Lawyer by *Texas Monthly* and *Law and Politics Magazine* from 2003 through 2015 as well as named to Best Business Lawyers in Tax by *D Magazine* in 2009, Best Lawyers in America, Tax Law in 2009 through 2015, and Best Go-To Tax Lawyer, by *Texas Lawyer Magazine*.

He resides in Dalworthington Gardens, the smallest municipality in the Metroplex, is married to Carol, and has two sons and two grandchildren. Mr. Cousins was admitted to practice in Texas in 1980.

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