San Antonio Estate Planning Council

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Don't Give Up On Discounts

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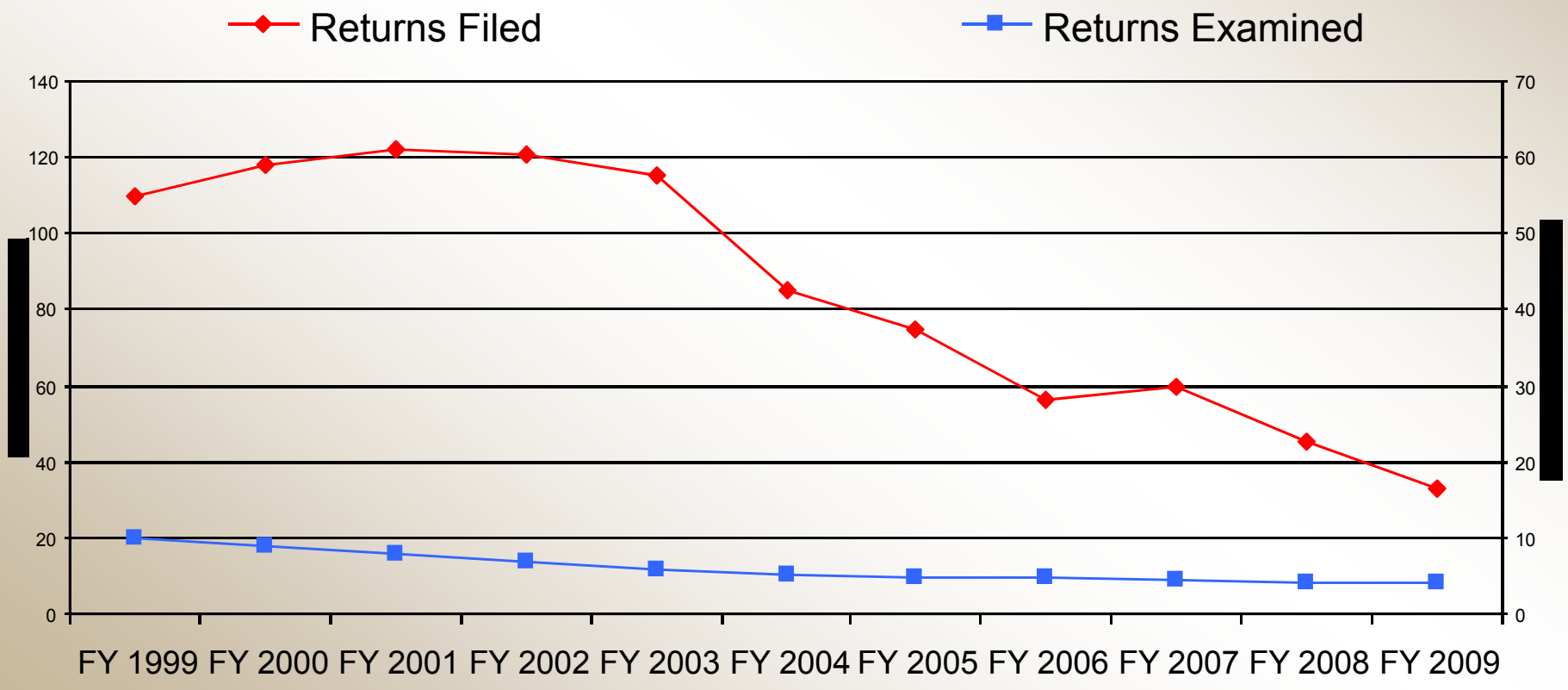
Family Limited Partnerships ("FLP's")

I will discuss FLP's in five contexts:

- Audit Incidence
- Issues
- Pre-Litigation Tactics
- Litigation
- Legislation

IRS Enforcement: Estate Tax Audits

Examination Coverage of Estate Tax Returns. During FY 2009, the number of estate tax returns filed decreased by approximately 13%. Of the 33,515 706's filed in FY 2009, only 44% were taxable.



Source: IRS Data Book.

FLP's: Issues

Formation Issues:

- Existence of Partnership at date of death – *Church v. U.S.*, 85 A.F.T.R. 2D (RIA)804 (W.D. Texas 2000, aff'd per curiam 268 F.3d 1063 (5th Cir. 2001)
- Funding of Partnership – *Keller v U.S.*, Civil Action No. V-02-62 (S.D. Texas, August 20, 2009).
- Competence of older generation participants.

FLP's: Issues (continued)

- Estate of Murphy Argument – *Murphy v. Comm'r*, 60 TCM 645 (1990).
- The Internal Revenue Service has historically exaggerated the *Murphy* decision to mean that formation/transfer of FLP interests done primarily for tax purposes should be disregarded.
- This overstates the decision – see *Kerr v. Comm'r* 113 TC 449 (1999).

FLP's: Issues (continued)

Murphy argument continued:

- The Service now uses *Murphy* in a more limited manner: To attack close-to-death transfers of FLP interests – especially where they result in a control shift.

- The defense the Estate must show is a substantial non-tax motivation for the transfers.

FLP's: Issues (continued)

§ 2036 Attacks - have worked well for the I.R.S.:

- The Internal Revenue Service's primary use of Section 2036 was blunted by the Taxpayer victory in *Kimbell v. U.S.*, 244 F. Supp. 2d 700 (N.D. Tex 2008) reversed on appeal 371 F.3d 257 (5th cir. 2004).

FLP's: Issues (continued)

Kimbell provided a roadmap for avoiding Section 2036 by fitting into a parenthetical language of Section 2036(a) [bona fide sale for an adequate and full consideration]:

- Equity interests of each partner must be *proportional* to the F.M.V. of contributed assets;
- Value of contributed assets properly credited to partner capital accounts; and
- At dissolution all partners entitled to distributions in amounts equal to their capital accounts.

FLP's: Issues (continued)

After *Kimbell*, the Internal Revenue Service shifted its attack to the factual argument that operation of the FLP indicated an informal agreement between the partners that the older generation could reach the transferred assets. Courts, especially the Tax Court, have been receptive to this argument.

FLP's Issues: Informal Agreement

The Internal Revenue Service's attacks have focused on a variety of factual points:

- Failure to leave sufficient assets outside the FLP on formation;
- Failure to observe partnership formalities-income recognition, payments of personal expense, etc.
- Uncompensated use of partnership property;
- Disproportionate distributions; and
- Post date-of-death access to partnership funds to pay estate taxes.

FLP's Issues: Informal Agreement
(continued)

The practical impact of this argument is to shift the audit focus to operation of the FLP. This has resulted in the issuance of exhaustive Information Document Requests ("IDR") looking at partnership records.

FLP's Issues: Valuation Dispute

- The ultimate FLP disputes involve valuation of the underlying assets and the entity level discounts;
- The trend is more sophisticated valuation reports, more attuned to the particular factual pattern than the mere recitation of academic studies estimating discount rate.

FLP Pre-Litigation Tactics

- There is substantial regional variation in Internal Revenue Service attitudes toward FLP's and discounting.
- Section 2036/Informal Agreement Argument requires extensive examination of FLP operations.
- Section 7491 encourages estate representatives to engage in the Internal Revenue Service at audit.
- Increasing settlement of "clean" FLP's at audit and appeals – although appeals availability is problematic.

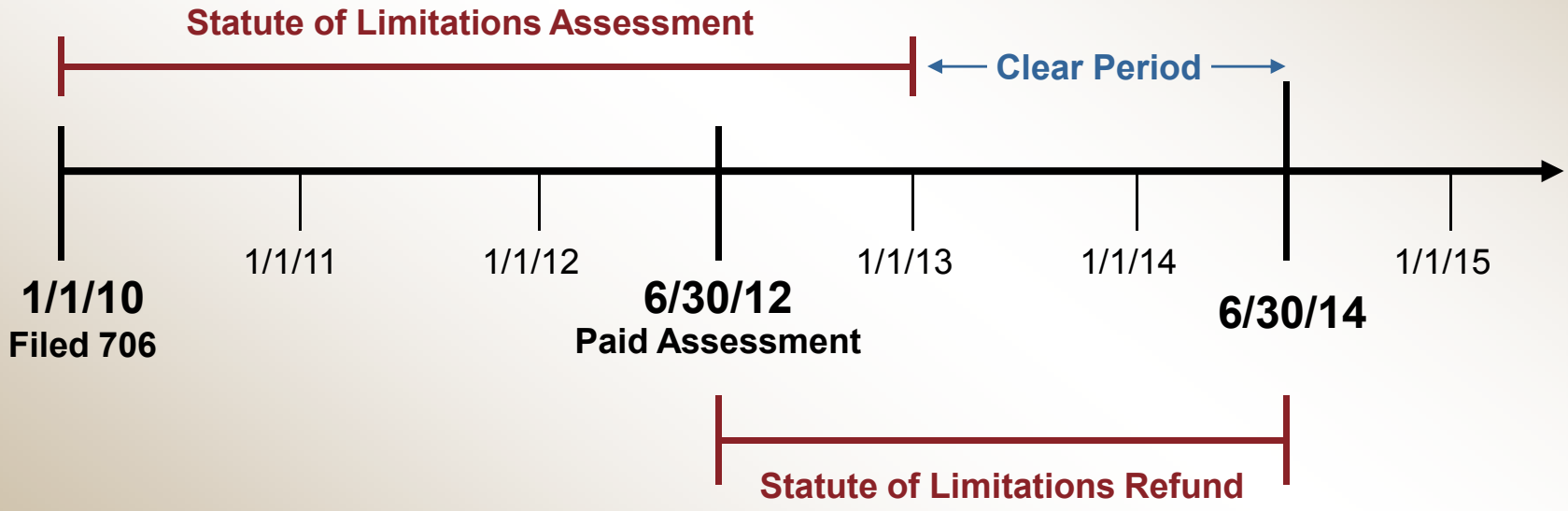
FLP Litigation Tactics

- While the bulk of all tax disputes go to the Tax Court, note increased shift to refund litigation in District Court.
- Some perception that Taxpayers do better in District Court.

When a Deal Isn't Final

Example: Let's assume that the Estate timely files the 706 on January 1, 2010. Further that, an examination occurs resulting in a settlement, with an agreed deficiency in Estate Taxes on May 1, 2012; well within the normal 3 year statute of limitations on assessment. Form 890 is executed, a billing generated and payment of the additional tax occurs June 30, 2012. The Estate took the settlement to limit its downside risk for additional taxes, but wanted to maintain the option of arguing for a reduction in tax. The statute of limitations on assessment will run on December 31, 2013; the refund statute of limitations will run June 30, 2014. As such there is a clear 18 month period in which a Refund Claim (Form 843) is timely, but during which it is impossible for the IRS to assert an additional deficiency (1/1/2013 through 6/30/2014). A Refund Claim filed during that period could give rise to a refund action in the U.S. District Court (with proper venue) 6 months after filing. In such, a suit the government would be allowed to reopen the original return to create a counterclaim for additional offsetting taxes, but would not be allowed to bring suit for a net deficiency--in other words the Estate can pursue its refund with no fear of a net amount due.

When a Deal Isn't Final
(continued)



FLP's Legislation

At least 3 attempts (twice under President Clinton, once under President Bush) to limit FLP discounting were not able to emerge from committee.

- Current discussion centers on:
  - Modification of family attribution rules to remove discount for lack of control.
  - Limitation on discounting for passive entities.

Future of Discounting

If Family Attribution rules are modified that will only effect control discounting, so the marketability discounts may surge.

- There is discussion on constitutional attacks: Don't Hold Your Breath.
- Shift will be to other forms of discounts:
  - Asset level discounts where appropriate:
    - Environmental
    - Undivided interest discount
  - Discount for lack of certainty – See *Adams v. U.S.,* 218 F.3d 383 (5th Cir. 2000).

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Information included in these slides is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any penalties under U.S. federal tax law, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

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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 and Keller v. United States*. He successfully argued the Fifth Circuit appeals in *Adams* and *Kimbell*.

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 2010 as well as named to Best Business Lawyers in Tax by *D Magazine* in 2009 and Best Lawyers in America, Tax Law in 2009 through 2011. He resides in Dalworthington Gardens, the smallest municipality in the Metroplex, is married to Carol, and has three sons and two grandchildren. Mr. Cousins was admitted to practice in Texas in 1980.