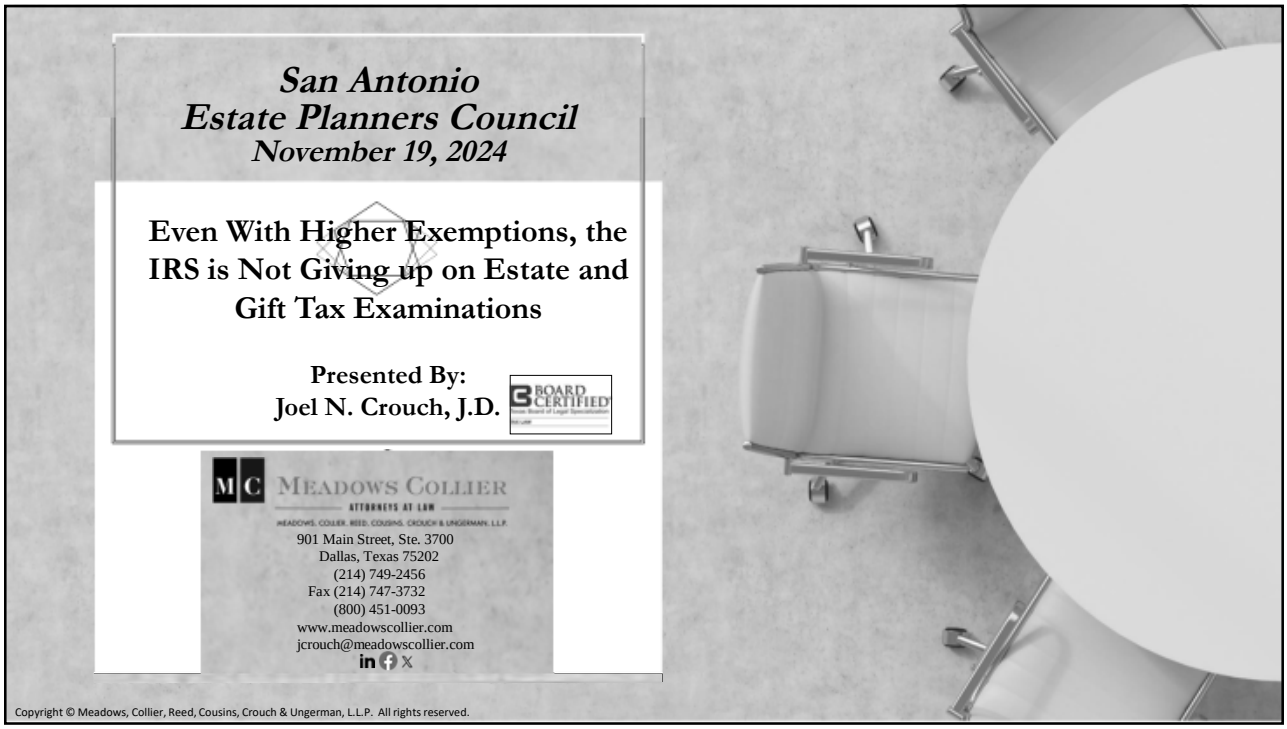

FRONT LINES OF IRS ENFORCEMENT IN THE ESTATE AND GIFT ARENA

- Valuation Discounts
- Tax Affecting
- Defined Value Clauses, i.e., Wandry Clauses
- "Reciprocal" SLATs
- IRC Section 2036 challenges
- GRAT Audits

STRESS TESTING THE ESTATE PLANNING

- Now is the time to stress test the planning. What can we do to backfill and fix the problems before it is too late?
  - Have gift tax returns been filed and do they adequately disclose the gifts?
  - Have all the income tax returns been filed?
  - Do the tax returns, transfer documents and appraisals match?
  - Are the entities in good standing?
  - Are the clients respecting the legitimacy of the entities and following formalities?
  - Is the client relying on distributions from the entity or is it making disproportionate distributions?
  - Is the client commingling personal assets with entity assets ("living out of the partnership") or using partnership assets (vacations at the Aspen condo and Maui pad)?
  - Are there transfer documents evidencing contributions to the entity?

STRESS TESTING THE ESTATE PLANNING

- Continued stress test planning:
  - Have you documented the non-tax purposes for the entity?
  - Have you documented adequate and full consideration for the issued entity interests?
    - Contribution Schedule
    - Ownership Percentages
    - Capital Account Ledgers
  - Does client have books and records for the entity?
  - Are property taxes and other expenses being paid by the entity?
  - Is property liability insurance being paid by the entity?

STRESS TESTING THE ESTATE PLANNING

- Continued stress test planning:
  - Is there any personal use of entity property?
  - Is there any commingling of entity assets?
  - Has client retained assets for own support and maintenance?
  - Do the partners conduct an annual meeting and prepare minutes?
  - If children or trusts own entity interests, have gift tax returns been filed?
  - Are there prior sales or other non-gift transactions that have not been disclosed on prior returns? Agent will request statement for operating accounts and search for non-disclosed gifts.
  - Does client have Crummey letters for gifts? If not, can you establish actual knowledge of gifts by beneficiaries?

IRS AUDIT TIPS

- Know the process.
- Know when to run for cover.
- Never sell yourself short on discounting.
- Know when to play them; know when to (temporarily) fold them.
- Find the weakest link and consider putting it at the front of the chain.
- Save your bullets when expert input is sought by the IRS examiner.
- Know what the examiner can and can't do.
- Know when you need back-up.
- Be ready for a long-distance relationship.
- Be diligent in preparing for post-audit.

TIPS FOR WORKING WITH IRS EXAM

- Be prepared
- Courteous?
- Keep notes of all communications.
- Follow up with confirming fax or email.
- Understand the agent's limits.
- Do we disclose obvious issues?
- Statute of Limitations
- Protective Refund Claims
- Can we shift the burden of proof?
- Keep quiet.

WHAT ABOUT REFUND CLAIMS?

- A timely refund claim generally must be filed within the later of (i) three years from the date a timely returns was filed, or (ii) two years from the time the tax was paid.
- What if the IRS denies my refund claim?
  - A taxpayer has two years to file a refund suit in federal court.
  - The two-year deadline to file a refund suit continues to run while IRS Appeals is considering a refund claim initially denied by the IRS.
- What if the IRS ignores my refund claim?
  - After six months, a taxpayer *may* file a refund suit in federal court.
  - The two-year deadline by which a taxpayer *must* file a refund suit does not begin until the IRS responds (in writing) and denies the refund claim.

TIPS FOR WORKING WITH APPEALS

- Produce a good protest.
- If a rebuttal report is filed, obtain a copy.
- File a Freedom of Information Act request, Direct Release and/or ask for a copy of the administrative file.
- Appeals can consider risks of litigation.
- Keep quiet.

ESTATE OF FIELDS V. COMMISSIONER T.C. MEMO 2024-90

- Another problematic fact pattern involving death bed planning that falls victim to Section 2036(a).
- Estate plan implemented for the decedent by her great nephew using a power of attorney that named him as the decedent's attorney in fact.
- Planning started in May 2016 after decedent, who had previously been diagnosed with Alzheimer's, fell and whose health had significantly deteriorated.

ESTATE OF FIELDS V. COMMISSIONER

- May 2016 AM Fields Management was formed with the grand nephew, who is the sole member and manger, contributing $1000. Partnership of AM Fields, LP ("FLP") was formed with the grand nephew executing the partnership agreement on behalf of the decedent.
- Shortly thereafter, the FLP was funded with various assets of the decedent, with a value of approximately $17 million.
- In June 2016, the hospice care was recommended for the decedent who died on June 23, 2016.
- For estate tax purposes, decedent's 99.9941% LP interest was valued at $10.8 million which included a 15% discount for LOC and a 25% discount for LOM.

ESTATE OF FIELDS V. COMMISSIONER

Estate's Non-Tax Purposes

1. The FLP protected the decedent from further instances of financial elder abuse.
2. The FLP allowed for the grand nephew to choose his successor to manage the FLP.
3. The FLP resolved the issues of third parties refusing to honor the decedent's power of attorney.
4. The FLP allowed for consolidated and streamlined management of assets.

ESTATE OF FIELDS V. COMMISSIONER

The court was troubled by the following:

1. The decedent was not personally involved in any of the partnership planning or management.
2. Any instances of elder abuse occurred years before the formation and funding of the FLP.
3. The assets transferred to the FLP did not require active management.
4. There was not major changes in the amount or composition of the decedent's assets leading up to the formation of the FLP.
5. The decedent contributed virtually all the assets of the FLP, thus there was not potential for "intangibles stemming from a pooling of assets for joint enterprise."

ESTATE OF FIELDS V. COMMISSIONER

Tax Court's Section 2036(a) findings:

1. The GP had discretion to make distributions, and, through the grand nephew, the decedent effectively had the right to virtually all the income from the assets transferred to the FLP.
2. Decedent retained the enjoyment of the assets under Section 2036(a)(1).
3. Decedent, in conjunction with the grand nephew, could dissolve the partnership and was able "to designate the persons' who shall possess or enjoy the property or the income therefrom."
4. The transfers to the FLP did not constitute bona fide sales for adequate and full consideration.

ESTATE OF FIELDS V. COMMISSIONER

- Regarding penalties the estate argued that it had reasonable cause for the underpayment and acted in good faith. Alternatively, the estate argued that the grand nephew reasonably relied on competent and informed professional tax advice.
- The court said that there was no evidence that the grand nephew "personally considered, researched, or understood the implications of Section 2036 for the Estate's estate tax liability and that the discount was obviously "too good to be true".
- With regard to the reliance defense, the court said there was no evidence that showed any professional provided tax advice regarding the discount taken on the estate tax return.

SCHLAPFER V. COMMISSIONER T.C. MEMO 2023-65

- First reported case with a detailed discussion of the adequate disclosure requirements under the gift tax adequate disclosure regulations (Reg. Section 301.6501(c)-(f).
- Applies a lenient "substantial compliance" approach.
- Compare to IRS informal guidance that applies a stricter approach.
- Why is this important? If the gift is adequately disclosed, it starts the three-year statute of limitations.

MCDOUGALL V. COMMISSIONER
163 T.C. NO. 5 (9-17-24)

- The case addresses the early termination of a QTIP trust.
- The spouse/beneficiary intended to engage in freezing transactions to minimize future estate tax.
- The Tax Court said the spouse/beneficiary did not make a gift of the remainder interest under Section 2519.
- However, the children/remainder beneficiaries made a gift by agreeing that all assets could be distributed to the spouse/beneficiary.
- No guidance on how this gift should be valued.

SORENSEN V. COMMISSIONER
T.C. DOCKET 24797-18, 24798-18, 20284-19 AND 20285-19

- Two cases settled by a stipulated decision on August 22, 2022.
- Relevant Facts:
  - The donors relinquished dominion and control of the 9,385 shares (approx. 30% of each brother's nonvoting interests) for $532.79 per share on December 31, 2014 (not a formula amount?) and sold another 5,365 nonvoting shares for a $2,858,418 promissory note (using the same appraisal) (not defined value transfers) on March 31, 2015.
  - Firehouse Restaurant Group, Inc. sold for almost $1B on November 15, 2021. Each trust received about $150 million.
- Issues: Are Wandry clauses respected? What was the appropriate FMV of the shares on the various transfer dates (could the same appraisal be utilized)? Were penalties reasonable?
- Outcome: IRS win (maybe). Formula clause did not apply; 10% accuracy penalty apply to 2015 transfer; gift tax paid. Although the case settled without trial, it provides notable lessons.
- Takeaway: Valuation was central to the case but it's also an example of how a Wandry clause could be otherwise interpreted by the Service and provides the IRS's arguments regarding such clauses and how terms can be distinguished from Wandry.

LESSONS TO LEARN FROM SORENSEN

- Treatment of Wandry transfers varies among IRS estate and gift tax attorneys.
- Beware of Wandry transfer if transferred assets could explode in value.
- Reporting consistency (stock ledgers, distributions, donee acknowledgement of stock power, third parties).
- Use update appraisals, since a 3-month old appraisal may have resulted in 10% penalty where conditions changes.

ESTATE OF HOENSHEID V. COMMISSIONER T.C. MEMO 2023-34

- Relevant Facts: Case involved assignment of income and availability of charitable deduction.
- Issues:
  - Did the taxpayer make a valid contribution of the shares of stock and, if so, when, and was the unreported capital gain income due to proceeds from the sale of those shares fixed before the gift?
  - Was a charitable contribution deduction available to the taxpayer and did accuracy-related penalties apply for the underpayment of tax?
- Outcome: IRS win.
  - The Tax Court held that an individual made a valid gift of stock in a closely held corporation to a DAF but, importantly, the right to income was fixed before the donation and, therefore, the taxpayer recognized gain on the sale of the stock.
  - The charitable deduction was denied due to failure to provide “qualified appraisal.”
  - No penalty because reasonable reliance on attorney’s advice, even though it was wrong.

KEEFER V. U.S.
130 AFTR 2D 2022-5405

- Also, an assignment of income case involving a donation to a charity.
- Donation of a 4% LP interest in a hotel being sold by the partnership.
- Oral side agreement that the charity would share in the proceeds from the sale of the hotel but not other partnership assets.
- Assignment of income doctrine applied because donor assigned only a portion of interest attributable to donated 4% limited partnership interest (proceeds of hotel sale only).
- Donor recognize income on sale of the hotel.
- Income tax charitable deduction denied because charity did not properly acknowledge that it had exclusive legal control over donated assets.

ESTATE OF CECIL V. COMMISSIONER
T.C. MEMO 2023-24

- Gift tax valuation of voting and nonvoting stock of S-Corporation that owned Vanderbilt Biltmore House in Asheville, N.C.
- Taxpayer and IRS experts both tax affected earning of the S corporation in valuing the company under the income approach because the data used for the valuation were largely based on data from C corporations.
- After an extended discussion of the prior cases that rejected or allowed tax affecting, the judge begrudgingly agreed to tax affecting.
- Holding based on fact that experts on each side agreed to using tax affecting and the tax affecting specific method.
- "We are not necessarily holding that tax affecting is always, or even more often than not a proper consideration for valuing an S corporation."
- The court subsequently rejected the IRS's expert valuation, accepted the stock valuation of one of the taxpayer's experts before applying discounts and determining the appropriate discounts that should apply for lack of control and lack of marketability.

ESTATE OF DEMUTH V. COMMISSIONER T.C. MEMO. 2022-72

- Decedent's son, under a power of attorney that authorized him to make gifts, wrote 11 checks from decedent's account on 9/6/15.
- One of the checks was paid before decedent's death on 9/11/15.
- Three of the checks were deposited by the données before decedent's death but not paid.
- Remaining seven checks were all deposited and paid after decedent's death.
- Issue for the court was whether there were completed gifts.
- IRS conceded that the three checks could be excluded from the estate.
- Court held for the IRS on the remaining seven checks.

SMALDINO V. COMM'R, T.C. MEMO 2021-127 (NOV. 10, 2021)

- Relevant Facts: Husband owned an LLC and desired to transfer an interest in the LLC to a Trust for his children from a prior marriage.
  - Husband first gifted to Wife that number of LLC units equal in value to $5,200,000.
  - Wife then gifted those same units to the Trust for Husband's children.
  - Husband then gifted additional units to the Trust, equal in value to $1,000,000.
- Issue: The IRS alleged that the members disregarded corporate formalities and governance, and the entire transaction was part of a prearranged plan constructed solely for tax purposes.
- Outcome: IRS win. Tax Court collapsed the transaction, ignoring Husband's gift to Wife and treating the entire gift as made by Husband, resulting in a gift tax liability because Husband had insufficient remaining lifetime exemption to cover the entire gift.
- Takeaway: Respect for corporate formalities cannot be overlooked as IRS seems willing to question the documents used in planning transactions.

NELSON V. COMM'R, 17 F.4TH 556 (5TH CIR., NOV. 3, 2021)

- Relevant Facts: Mrs. Nelson desired "to make a gift and to assign to [the Trust] her right, title and interest in a limited partner interest having a fair market value of [$2,096,000.00] as of December 31, 2008, as determined by a qualified appraiser within [90] days of the effective date of [the] Assignment."
- Issue: Gift and sale of LP interest to SLAT using defined value clause as in, "having a FMV on [X] date, as determined by a qualified appraiser within [X] days." The IRS challenged valuations and proposed gift tax deficiencies due to the formula language.
- Outcome: IRS win. The Court held the Taxpayers to the value determined by the appraiser, not the value as "finally determined" for tax purposes. The Court essentially approved the use of formulas (as well as tiered discounts, for that matter).
- Takeaway: Recognize the types of formula clause language, including defined value, Wandry, and King; the IRS will enforce what is written!

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Joel is a frequent speaker on procedural and substantive tax issues for legal and accounting professionals. Some of his topics include: Tax Shelter Defense, IRS Examinations, Appeals, Litigation and Collection Strategies, IRS Criminal Investigations, IRS Offshore Activities, IRS Focus on Tax Professionals, Employment Classification, IRS Penalties, and Litigation Partnership Tax Cases. He has also published various articles regarding the IRS and tax procedures.

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