

**TRANSFER TAX CONTROVERSY PROCEDURE:  
PRACTICAL ISSUES**

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## **TRANSFER TAX CONTROVERSY PROCEDURE: PRACTICAL ISSUES**

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Even though federal gift, estate and generation-skipping transfer taxes generate only a very small percentage of the total tax revenue collected by the Federal Government, IRS transfer tax agents generate substantially more revenue on a per capita basis than their counterparts in the other areas of the IRS. Thus, the audit of gift and estate tax returns offers the IRS a greater return on its investment of time and money than audits of income tax returns. It should come as no surprise that the IRS, in an effort to efficiently utilize its limited resources, emphasizes audits in the transfer tax area.

Estate tax return audits and appeals are handled by attorneys who have special training in the estate and gift tax area. The examiner and the appeals officer will have training in both basic and sophisticated estate planning techniques. With that in mind, this outline discusses both (1) techniques which have proven useful in proactively avoiding confrontations with the IRS, and (2) the preparation, dynamics, and strategies involved once the IRS has selected the estate tax return for audit.

### **I. DEFENSIVE PREPARATION OF THE ESTATE TAX RETURN.**

#### **A. Do It Right the First Time.**

Consider the return as “Petitioner’s Exhibit 1” in your potential estate tax case -- it usually is! Always prepare the estate tax return assuming that the return will be audited.

A well-organized, complete, and understandable return which contains all required schedules, supporting valuations, gift tax returns, and other documents required to be submitted with the return is the first step in establishing your credibility with the examiner. Be certain to attach all required supplemental documents to the return. These include a certified copy of the last will and testament, Form 712, Form 709, Form 706CE, trust instruments, powers of appointment, death certificate, and state certification of payment of death taxes. If the return is poorly prepared or if any of the supplemental documents are missing, the examining agent may believe that the taxpayer did not obtain supporting data for valuations or give proper consideration to the preparation of an accurate return. Obtain necessary appraisals early.

#### **B. Be Particularly Aware of “Red Flag” Items.**

The IRS Estate Tax Examiner’s Handbook identifies certain classes of items in a return which are more likely to be incorrect and which bear a closer scrutiny than the average item. You can expect these items to be examined closely; and thus special care should be given to reporting these items in the return. These “red flag” items include:

**1. Any Mention of the Word “Discount” to Explain the Valuation of an Asset.**

The use of discounts to explain the valuation of an asset, either in a schedule to the return or in an appraisal, is a signal for the value reported. The IRS Handbook states that such returns deserve special attention. The IRS’s predisposition to scrutinize such returns emphasizes the need for the appraisal of such assets from a well-respected, qualified, and independent appraiser.

**2. Fractional Interests.**

Fractional interests will also receive special attention from the examiner. The valuation of the fractional interest, which often contains a substantial discount, must also be supported by the opinion of a well-respected, qualified, and independent appraiser.

**3. Trusts with Crummey Withdrawal Powers.**

Expect the examiner to ask for copies of the Crummey letters from the trustee, and whether any of the withdrawal rights were exercised.

**4. Claims Against the Estate by Heirs.**

The IRS Handbook provides that the payment of the claim to an heir or family member of the heir’s estate may be nothing more than a family arrangement for a partial distribution of the decedent’s estate, motivated by desire to reduce the amount of Federal estate tax. The return should demonstrate that the debt is a bona fide debt for full consideration in money or money’s worth. This can often be done by simply setting forth terms of the debt and, if the debt is evidenced by a written agreement or security, the terms of the written agreement and the interest secured. In addition, if there are adverse interests between the claimant and the other heirs of the estate, the terms of the dispute could be spelled out in the description of the claim.

**5. Promissory Notes to Family Members.**

As with claims against the estate by heirs, the terms of the written agreement evidencing the obligation should be spelled out in the return and any security for the note should be identified.

**6. Charitable Bequests.**

Make sure the beneficiary is a qualified charity and there is no contingency which prevents the charity from taking the amount claimed. If the Will contains a non-qualifying split interest gift, consider a “qualified reformation” of the governing instrument in accordance with I.R.C. § 2055(e). The qualified reformation proceeding must be initiated 90 days of the date the estate tax return is required to be filed (including extensions). I.R.C. § 2055(e)(C)(iii)(I).

**7. Surviving Spouse.**

Make sure there is no contingency which prevents the spouse from taking the amount claimed.

**8. Safety Deposit Box Identified but No Property Listed.**

Self-explanatory.

**9. Inherited Property.**

The examiner will trace significant inherited assets to the prior decedent's gross estate. The examiner will look primarily for inconsistent valuation positions -- this is especially relevant where the valuation dates are close. Obtain any valuations included in the prior decedent's return and be prepared to explain the reason for any significant differences.

**10. Missing Supplemental Documents Which Were Required to be Filed with the Return.**

This may indicate that the taxpayer did not obtain supporting data for valuations or give proper consideration to the preparation of an accurate return.

**11. Deductions Claimed for Appraisals Which Are Not Included with the Return.**

If the taxpayer or the taxpayer's representatives have obtained an appraisal or consulted with an appraiser and you are not particularly interested in sharing that appraiser's conclusions with the IRS, do not deduct the cost of the appraisal as an expense of administration. In cases where the cost of the appraisal is deducted as an expense of administration but the appraisal is not attached to the return, the examiner will likely ask for a copy of the appraisal. If the examiner does not know that the appraisal exists, he may not ask for it.

**II. THE FEDERAL ESTATE TAX EXAMINATION.**

**A. What Happened to My Return?**

Estate tax returns are filed and shipped to the IRS service center in Cincinnati, Ohio. All estate tax returns are individually reviewed (which is unique to estate tax returns) to determine their audit potential.

If items are missing, the IRS will initiate action to obtain the necessary information. If the requests for additional information go unanswered or if there are issues to be looked into further, the return is mailed to the appropriate district office for a follow-up audit. If it is determined that the return is lacking sufficient required information to make an informed decision of whether or not to audit the return, the estate tax manager can request additional information. Once the additional information is obtained, the estate tax manager has four options:

**1. Survey Before Assignment.**

The estate tax manager determines that even though the return was selected during the classification process, the issues involved do not warrant an audit. At this time, the return will be accepted as filed, and a closing letter will be issued.

**2. Survey After Assignment.**

The return is assigned to an examiner who, after reviewing the return's audit potential, decides an audit is not necessary. This case can be closed with managerial concurrence, and a closing letter issued.

**3. Limited Scope Audit.**

The estate is assigned to an examiner with instructions to limit the audit to only one or two readily identifiable issues.

**4. Regular Examination.**

The taxpayer is contacted by an examiner and notified that an audit is to be conducted. The regular examination is the customary estate tax audit.

**B. The Timing of the Estate Tax Examination.**

Estate tax returns are ordinarily examined in the order in which they are filed -- on a first in, first out basis. An estate tax examination should be initiated within nine months of the return filing date. Absent unusual circumstances, an estate tax audit is required to be completed within eighteen months from the date the return is filed.

**C. Scope of the Estate Tax Examination.**

The examination will extend to all unusual, large, and questionable items necessary for a substantially correct determination of tax liability. The examiner is expected to pursue only significant issues and these only to the point that conclusions can be reached which are supported by relevant facts and correct application of the appropriate law to the facts. The meaning of "significant" will depend upon the examiner's perception of the return as a whole and the separate items that comprise the return. Among the several factors that must be considered when determining whether or not issues are significant are:

- (a) comparative size of the item;
- (b) absolute size of the item;
- (c) inherent character of the item;
- (d) evidence of intent to mislead;
- (e) beneficial effect of the manner in which an item is reported;

- (f) relationship to/with other item(s) on the return; and
- (g) relationship between the size of the item and the tax liability.

The examining agent must advise the taxpayer or the taxpayer's representative of all matters that will be covered during examination to the extent identified during pre-contact analysis. The scope of the examination should not be later expanded without justification. If the examiner does not volunteer the scope of the examination at the time the audit begins, do not hesitate to ask.

#### **D. The Estate Tax Examination.**

An attorney representing the taxpayer in a dispute with the IRS must file a power of attorney authorizing him to act for the taxpayer.

The interview examination method will be used for returns examined by estate tax attorneys unless information concerning all questionable items appearing on a tax return can be readily furnished by mail.

Before contacting the taxpayer, expect the examiner to have thoroughly reviewed the estate tax return, all related gift tax returns, and the administrative file. By this time, the examiner should have performed a pre-audit analysis and preliminarily researched all issues considered as a part of the analysis. The examiner should have a list of questions to be answered and additional documents which need to be reviewed.

Unless the examination is a limited scope examination, the estate tax attorney may interview the executor, trustee or other qualified representative to ascertain:

- (a) the decedent's history, including the sources of the decedent's wealth, the natural objects of the decedent's bounty, the decedent's physical and mental condition during the final years of his/her life, and how the decedent's financial records were organized; and

- (b) significant developments during the administration of the decedent's estate which may be relevant to a correct determination of the tax liability, including the appraisal and sale of assets included in the gross estate and the resolution of any litigation pending at the time the return was filed.

In addition, the estate tax attorney will make an adequate probe for omitted assets and undisclosed transfers, including:

- (a) review of appropriate evidence relevant to a "yes" answer to any of the disclosure questions on the estate tax return including the wills, trust instruments and applications for life insurance policies;

- (b) inquiry regarding the absence of assets normally associated with the decedent's business or profession;

(c) review of appropriate public records including probate records, deed records and indexes, and local real estate tax assessment records;

(d) review of the decedent's Form 1040 for the year of death and one preceding year with particular emphasis on reconciling sources and amounts of income on the Form 1040s, U.S. Individual Income Tax Return, with corresponding assets and values on the estate tax return;

(e) review of all related Form 709s;

(f) review of appropriate financial and tax records of the decedent and the estate; and

(g) review of appropriate stock transfer records of closely held corporations in which the decedent had a significant interest.

The examiner's work papers must identify which penalties were considered and contain sufficient analysis to support the conclusions to recommend (or not to recommend) such penalties be asserted. When suspicions of fraud are present, the examiner must develop the relevant facts to support a decision to refer (or not to refer) the case to the Criminal Investigation Decision. The examiner is encouraged to use specialists within the service, including outside fee appraisers, and paraprofessional support personnel, in examinations.

### **III. PRIVILEGES IN THE ESTATE PLANNING CONTEXT**

Because of the recent IRS attacks on family limited partnerships and limited liability companies, IRS requests for documents at the audit level and in estate tax litigation increasingly include requests for communications with counsel and other persons involved in the estate planning process seeking to determine the motives for creating the entity. This is particularly true in the area of buy-sell agreements, family limited partnerships, and closely-held corporations, where the IRS has become more aggressive in seeking to have entities ignored for estate tax purposes on the grounds that the entity lacks "business purpose" or was created solely as a "device" to avoid estate taxes. Attached as Exhibit 1 is an example of the type of IRS document requests that have been served on taxpayers over the last several years in audits involving closely held entities. The requests are extremely intrusive and cover every aspect of the estate planning and entity administration process.

#### **A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience.**

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning

process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their correspondence and their files may also be subject to production in a tax audit or in litigation.

## **B. Understand the IRS's Broad Subpoena Power.**

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

*Subject to any applicable privileges*, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

## **C. Understand and Preserve All Privileges.**

As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffe v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney-client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to

medical records, the doctor/patient privilege and psychotherapist/patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

## **1. The Attorney-Client Privilege.**

### **a. What the Privilege Covers.**

The attorney-client privilege generally protects the disclosure of confidential communications between counsel and the client made for the purpose of facilitating the rendition of legal advice. The attorney-client privilege also protects “an attorney’s advice in response to such disclosures.” *In Re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). In addition, “[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when lawyers represent their clients in litigation.” *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Communications with third parties, such as accountants or financial advisors, that are made to “assist the attorney in rendering advice to the client” are also generally protected. *See United States v. Adlman*, 68 F.3d 1495, 1499 (2d Cir. 1995). (“[T]he privilege would extend to . . . an accountant hired by the attorney to assist the attorney in understanding the client’s financial information.”)

A privileged communication is “any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression.” *See, e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass’n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) (“[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege.”); *New York Underwriters Ins. Co. v. Union Constr. Co.*, 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney’s billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir. 1982) (holding that bills, ledgers, statements, time records, and the like that reveal “the nature of the services provided” should be privileged).

Courts generally define “client” broadly, even extending the privilege to include prospective clients who reasonably believe that they are seeking legal advice. The Supreme Court has also extended the privilege to all corporate employees of a represented taxpayer if the communications at issue were made by corporate employees to counsel for the corporation acting as such, at the direction of corporate superiors in order to secure legal advice from counsel and the “employees . . . were . . . aware that they were being questioned in order that the corporation could obtain legal advice.” *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

The attorney-client privilege survives the death of the client. *Swidler & Berlin and James Hamilton v. United States*, 524 U.S. 399 (1998).

**b. What the Privilege Does Not Cover.**

Communications with nonclients such as stock brokers, accountants, or other third parties that are *not* made to “assist the attorney in rendering advice to the client” are generally not privileged. *Adlman*, 68 F.3d at 1499. “What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal advice from the lawyer*. If what is sought is not legal advice but only accounting service . . . or the advice sought is the accountant’s rather than the lawyer’s, no privilege exists.” *Id.* at 1499-1500, *citing United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Work papers of the attorney that do not constitute or contain communications from the client, drafts of documents, and correspondence with third parties do not fall within the attorney-client privilege. *See Hickman v. Taylor*, 329 U.S. 495, 508 (1947) (holding that the privilege did not attach to “memoranda, briefs, communications and other writings prepared by counsel for his own use in prosecuting his client’s case; and it is equally unrelated to writings which reflect an attorney’s mental impressions, conclusions, opinions or legal theories”).

In addition, advice rendered in connection with tax return preparation has been held not to be privileged. *See United States v. Frederick*, 182 F.3d 496, 500 (1999). The *Frederick* Court’s refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is “accountant’s work,” whether performed by an accountant or a lawyer. For lawyers who prepare tax returns for clients, *Frederick* is a must read case.

In *Frederick*, an attorney/accountant claimed the attorney-client privilege for work papers prepared in the process of preparing tax returns for his individual clients and their closely held corporations. The Court held that the lawyer’s “legal cogitations born out of his legal representation” that appeared in the work sheets for the preparation of the tax return would not be privileged, because of their use in tax return preparation. *Id.* at 501. Under the Seventh Circuit’s analysis, disclosures made by a client during tax planning might lose their privileged status if incorporated in any way in work papers leading to the preparation of a tax return by the same representative.

The situation in *Frederick* was particularly complex because the attorney knew that the IRS was investigating the taxpayers and their company with regard to other tax years, and the attorney was representing the taxpayers’ interests in connection with the investigation as well as preparing their current tax returns. *Id.* at 501. The tax return work papers could contain privileged information related to the years under investigation and could have dual purposes – litigation preparation and return preparation. The Court held that the “dual purpose” documents prepared for both tax return preparation and litigation were not privileged because of their relationship to the tax return.

In addition, the Court dealt with the question of whether documents prepared in connection with a tax audit are privileged. The Court viewed the audit as “both a stage in the

determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation.” *Id.* at 502. In its original opinion, the Court treated all audit representation the same way – as not qualifying for the privilege. However, the Court amended its opinion to provide that if the audit primarily concerns “verifying the accuracy of a return,” then the audit representation is “accountant’s work” whether done by an accountant or a lawyer. If the taxpayer’s lawyer attends the audit “to deal with issues of statutory interpretation or case law that the revenue agent may have raised” in the audit, then the “lawyer is doing lawyer’s work and the attorney-client privilege may attach.” *Id.*

If the client retains an accountant to deal with verification and an attorney to do the “lawyer’s work,” then separating privileged communications from unprivileged communications during the audit is easy. Such separate representation is rarely practical. Any tax practitioner or court trying to separate privileged communications from unprivileged ones in a tax audit may face a very difficult process of sorting matters out after *Frederick*.

### c. Waiver.

Beware: even if a document is privileged, that privilege can be waived. Disclosing otherwise privileged communications between a lawyer and client to third parties may cause those communications to lose their privileged status. *See, e.g., United States v. Brown*, 478 F.2d 1038 (7th Cir. 1973).

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made “to assist the attorney in rendering advice to the client,” are protected under the attorney-client privilege. *See, e.g., Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney’s direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) (“Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation.”); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (providing short form opinion did not constitute waiver of attorney work product privilege); *In re G-I Holdings Inc.*, 218 F.R.D. 428 (D. N.J. 2003) (privilege deemed waived by asserting reasonable cause defense on the basis of legal advice). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made “in confidence for the purpose of obtaining legal advice.” *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir, 1973).

In a dispute we handled several years ago over whether the Service’s summonses were enforceable in light of privilege issues, we argued that a holding of waiver in the context of communications to and from the client’s financial advisors – where the communications were necessary for the purpose of rendering legal advice to the client in forming a business entity – would be contrary to the logic of the principle of the attorney-client privilege. *Seegerstrom v. U.S.*, 87 A.F.T.R.2d 2001-1702, 2001 WL 263449 (N.D. Cal. 2001). The Court granted the taxpayer’s request to quash the IRS’s summonses, given the facts - disclosure to third parties was shown to be necessary for the lawyer to render legal advice to the client.

*Olender v. United States*, 210 F.2d 795 (9th Cir. 1954), would appear to stand for the contrary proposition. However, such a conclusion ignores the factual setting of *Olender*, where the Court found that the only purpose for which the attorney in question there was hired was to prepare net worth statements and tax returns. *Id.* at 806. In the transaction planning context, “[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when the lawyers represent their clients in litigation.” *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). According to the Ninth Circuit, “[c]alling the lawyer’s advice ‘legal’ or ‘business’ advice does not help in reaching a conclusion [as to whether the communication is protected by the attorney-client privilege] . . . What matters is whether the lawyer was employed with or without ‘reference to his knowledge and discretion in the law’ to give the advice.” *Id.* at 1502.

## **2. The Attorney Work Product Privilege.**

Many lawyers believe that the attorney work product privilege absolutely protects their file from disclosure to third parties. The work product privilege is actually much narrower; it only shields from disclosure materials prepared “in anticipation of litigation” by a party or the party’s representative, absent a showing of substantial need. Fed. R. Civ. P. 26(b)(3). The purpose of the doctrine is to establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary’s preparation. *See United States v. Nobles*, 422 U.S. 225, 238 (1975).

There is no bright line test to determine whether a document has been prepared “in anticipation of litigation.” In the transaction planning process, however, it will be difficult to argue that an attorney’s internal memos or work papers were prepared “in anticipation of subsequent litigation” with the IRS. *See United States v. Adlman*, 96-2 U.S.T.C. ¶ 50,493 (S.D.N.Y. 1996) (refusing to apply the work product privilege to an accountant’s memorandum analyzing the “legal ramification of a proposed transaction to determine whether, despite a likely challenge, the legal risk was acceptable,” and holding that “[t]he primary purpose of these documents was not to prepare for litigation; the primary purpose was to decide whether or not to go through with a multi-million dollar transaction”), *aff’d in part and rev’d in part*, 68 F.3d 1495 (2d Cir. 1995) (nothing that there is no bar to “application of work product protection to documents created prior to the event giving rise to litigation”), *supp. proceeding*, 134 F.3d 1194 (2d Cir. 1998) (“a document created because of anticipated litigation, which tends to reveal mental impressions, conclusions, opinions or theories concerning the litigation, does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation. Where a document was created because of anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation”).

One court has even held that the power of the IRS to investigate the records of taxpayers makes doubtful the relevancy of the work product privilege enunciated in *Hickman* to a proceeding for the enforcement of an IRS summons. *United States v. McKay*, 372 F.2d 174, 176 (5th Cir. 1967) (reasoning that the IRS summons power is broad because all facts are in the taxpayer’s hands).

The recent decision by the district court in Maryland, though, shows the continuing applicability of the work product doctrine. The court held that documents were not subject to the Section 7525 privilege but were protected under the work product privilege. *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003).

### **3. The Tax Practitioner's Privilege.**

In the Internal Revenue Restructuring Act of 1998, Congress added I.R.C. § 7525, which extends the attorney-client privilege to confidential communications between taxpayers and practitioners that would protect the same “communication[s] between a taxpayer and an attorney.” The privilege, however, is limited to (1) “non-criminal tax matters before the Internal Revenue Service” and (2) “non-criminal tax proceedings in Federal court brought by or against the United States.” I.R.C. § 7525. Because the work product doctrine is separate from the attorney-client privilege, the new privilege provision does not grant the work product privilege to non-attorney advisors.

*Frederick* was the first case to address the tax practitioner privilege. The *Frederick* court took I.R.C. § 7525 into account in reaching its decision in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. *Frederick*, 182 F.3d at 502. Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

The First Circuit recently reinforced the *Frederick* court's construction of I.R.C. § 7525 in *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Cavallaro*, the First Circuit upheld the granting of enforcement of summonses issued by the IRS given that information was disclosed to accountants in a merger deal, and the accountants were providing accounting services, not facilitating communication of legal advice. The First Circuit reasoned that an attorney does not render client communications to an accountant privileged merely by engaging the accountant.

The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*, 237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the Section 7525 privilege did not extend to KPMG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by Section 7525 were in fact so protected. *United States v. KPMG*, 2003-2 USTC ¶50,691 (D. D.C. 2003). See also *United States v. BDO Siedman, LLP*, 225 F. Supp. 2d 918 (N.D. Ill. 2003), *aff'd*, 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

#### **4. The Physician-Patient Privilege.**

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992).<sup>1</sup> The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

However, in *Jaffee v. Redmond*, 518 U.S. 1 (1996), the Supreme Court addressed the question of whether federal courts should recognize a psychotherapist-patient privilege under Rule 501. In *Jaffee*, the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501. In reaching its holding, the Court noted that:

Like the spousal and attorney-client privileges, the psychotherapist-patient privilege is “rooted in the imperative need for confidence and trust.” *Trammel*, 445 U.S. at 51, 63 L. Ed. 2d 186, 100 S.Ct. 906. Treatment by a physician for physical illness can often proceed successfully on basis of a physical examination, objective information supplied by the patient, and the results of diagnostic tests. Effective psychotherapy, by contrast, depends upon an atmosphere of confidence and trust in which the patient is willing to make a frank and complete disclosure of facts, emotions, memories and fears. Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace.

*Id.* at 10. While the *Jaffee* Court did not rule on the applicability of a physician-patient privilege, the cited language shows that medical records based primarily upon physical examination and other objective information supplied by the patient or that result from diagnostic tests may not be considered privileged.

#### **5. Privileges in the Appraisal Process.**

##### **a. The Attorney Should Hire the Appraiser.**

In the transfer tax area, valuation appraisals often serve as the basis for a taxpayer’s position with respect to the value of transferred property. Working with appraisers is an everyday event for most transaction planning attorneys. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with

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<sup>1</sup> When Congress adopted the final version of the new Federal Rules Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (which included a physician-patient privilege) in favor of a single rule authorizing federal courts to apply “common law principles – in the light of reason and experience” in determining whether a privilege exists under the common law. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 “should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined as a case by case basis.” S. Rep. No. 93-1277, p. 13 (1974).

appraisers only in the purchase of their home. In addition, many clients do not enjoy working with appraisers. Although they are necessary, they are also expensive and can slow transactions down.

In most cases, the attorney, not the client, should hire the appraiser for a planning transaction. The attorney can offer guidance both to the client and the appraiser as to how similar transactions have been handled in the past by the IRS and the courts. Doing so will also provide the taxpayer with an argument that any unused reports or correspondence are privileged, as the appraisal was intended to assist the attorney in rendering legal advice. As noted above, this argument is not as strong in the “planning” stage. At the audit and litigation levels however, the attorney can argue that the documents are work product.

**b. Anything Committed to Writing May Be Discoverable.**

Any document in the appraiser’s file, including correspondence, notes, and drafts of an appraisal is subject to being discovered during the audit process or in subsequent litigation. Experienced appraisers should know this; however, it never hurts to remind them. Once again, consider who your audience may ultimately be and understand that the appraiser’s file may be reviewed by the examining agent, appeals officer, district counsel, or the ultimate finder of fact in tax litigation.

**c. Discuss the Methodology and Results of the Appraiser’s Work With the Appraiser Before the Appraiser Drafts the Report.**

Hiring a qualified appraiser is only the first part of the job. Examine the underlying assumptions, analysis, and conclusions of the appraiser and ensure that they are logical. Appraisers can and do make mistakes. Discuss with the appraiser his or her methodology of his or her examination *before* the appraiser commits the findings to writing. This doesn’t mean you should “coach” the appraiser or tell the appraiser the answer that you want; it does mean that you should satisfy yourself that the appraiser’s assumptions and analysis are correct. If you have questions or concerns regarding the appraiser’s assumptions or analysis, you should discuss those concerns with the appraiser before the appraiser begins drafting the report. If your concerns cannot be satisfied, consider choosing another appraiser. If you decide to engage a second appraiser *before* the first appraiser has reduced his findings to writing, there will be no documents from that appraiser to produce in response to an examining agent’s request for “copies of all appraisals.”

**D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client’s Best Interest to Do So.**

The assertion of the privileges at the audit or tax court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm’r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) (“Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons’ law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited

attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.”).

In cases where the IRS questions motives or business purpose, the best evidence can come from the correspondence prepared in connection with the transaction at issue. Well-drafted contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as “a device solely to avoid taxes” or lacks “business purpose.” *See, e.g., John J. Wells, Inc. v. Comm’r*, 47 T.C.M. (CCH) 1114, 1116 (1984). (“While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.”).

#### **E. The Effect of Asserting the Privilege on the Burden of Proof in Disputed Cases.**

In certain cases, the taxpayer can shift the burden of proof in transfer tax cases from the taxpayer to the government in the Tax Court. *See* I.R.C. § 7491. Section 7491 provides:

- (a) burden shifts where taxpayer produces credible evidence.—
  - (1) GENERAL RULE.—If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
  - (2) limitations.—
    - (A) the taxpayer has complied with the requirements under this title to substantiate any item;
    - (B) the taxpayer *has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews*; and
    - (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
- Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent’s death and before the applicable date (as defined in section 645(b)(2)).
- (3) COORDINATION.— Paragraph (1) shall not apply to any issue if any other provisions of this title provides for a specific burden of proof with respect to such issue.

I.R.C. § 7491 (emphasis added).

To shift the burden of proof, the taxpayer must have complied with the substantiation requirements and kept the required records. In addition, the taxpayer must have

cooperated with “reasonable requests” by the IRS for “witnesses, information, documents, meetings, and interviews” and must present “credible evidence” in court on the factual issue before the burden shifts. If the taxpayer asserts the privilege in response to an IRS request for information, the IRS will obviously argue that the taxpayer has not cooperated fully enough in providing information and should not be able to shift the burden of proof. The question yet to be addressed by the courts is whether a request that seeks privileged information can ever be “reasonable.”

#### **F. Privilege versus Penalty.**

Ironically, the price of asserting the privilege in particular cases may be the loss of other rights that would otherwise be available to the taxpayer or to the tax preparer. For instance, claiming the privilege may prevent taxpayers from showing that they have had substantial authority for a return position to avoid an accuracy related penalty, or prevent tax preparers from protecting themselves from tax preparer penalties.

Specifically, I.R.C. § 6662(a) imposes an accuracy related penalty in an amount equal to 20% of the portion of any underpayment to which the section applies. The section applies to, among other items, the portion of an underpayment attributable to negligence or disregard of rules or regulations. I.R.C. § 6662(b)(1). Negligence has been defined as the lack of due care or failure to do what a reasonable and ordinary prudent person would do under the circumstances. *Neely v. Comm’r*, 85 T.C. 934, 947 (1985). Negligence includes the failure to make a reasonable attempt to comply with the Internal Revenue Code. I.R.C. § 6662(c).

One defense to an underpayment penalty is that the underpayment of tax was made in good faith and due to reasonable cause. Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Treas. Reg. 1.6664-4(b). However, reliance on the advice of professional accountants or attorneys in preparing tax returns constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id.* See, e.g., *Schauerhamer v. Comm’r*, 73 T.C.M. (CCH) 2855 (1997). In order to demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise be privileged information. Accordingly, each case should be looked at on its own merits to determine whether or not the client will benefit by disclosure.

As a general matter, if the transaction is not a tax shelter under section 6662, the taxpayer may avoid understatement penalties if it has substantial authority for its position. It is not necessary to have a legal opinion *per se* as long as it is possible to demonstrate the existence of substantial authority.

If it is a tax shelter, then the taxpayer must have reasonable cause for its position and have taken such position in good faith. I.R.C. § 6662(d)(2)(B); I.R.C. § 6664(c). Until recently, most believed that a more likely than not opinion from a law firm would satisfy this standard. Care needs to be taken on the accuracy of the factual representations and the structure of the opinion to ensure that reliance on such opinion would constitute reasonable cause. See Circular 230; Treas. Reg. § 1.6664-4. Also, while so called “short form” opinions may provide

more comfort with respect to privilege concerns, they also may provide less comfort with respect to penalty concerns.

Reasonable cause may also exist, even though an outside legal opinion was not obtained, based on an analysis of the legal issues by employees of a company. To the extent in-house company lawyers review the tax issues, communications with such lawyers may also be privileged but it is important to demonstrate that such company lawyers, among other requirements, were acting in their legal and not business capacities. *See generally Upjohn v. United States*, 449 U.S. 383 (1981).

If a taxpayer relies on the opinion of counsel to avoid penalties, the taxpayer must produce such opinion and thereby waive its privilege, which could be interpreted as a broad subject matter waiver. *In re G-I Holdings*. If the opinion was procured only to avoid penalties, there is the further risk that such opinion did not enjoy a privileged status in the first instance.

The Section 7525 privilege does not apply to tax shelters, which would probably include listed transactions. Also, the IRS's current practice is to ask for audit work papers only if the transaction is a listed transaction. Ann. 2002-63. In terms of avoiding penalties, the taxpayer must have disclosed the listed transaction on its tax return pursuant to the reportable transaction regulations in order to rely upon the reasonable cause defense. Treas. Reg. § 1.6664-4(d). Finally, producing an opinion to avoid penalties will waive the privilege. *In re G-I Holdings*. It is also possible that obtaining an opinion solely to avoid penalties will also waive the privilege.

In *Johnston v. Comm'r*, 119 T.C. No. 3 (August 8, 2002), the Tax Court held that the taxpayer impliedly waived the attorney-client privilege by raising a claim that could be effectively disproven only through discovery of privileged information. The Johnstons rebutted fraud penalties with the defense of reasonable reliance on qualified experts in preparing income tax returns. Relying on *Hearn v. Rhay*, 68 F.R.D. 574, 581 (E.D. Wash. 1975), the *Johnston* court acknowledged four approaches<sup>2</sup> to implied waiver analysis, and focused on the three factors of the *Hearn* test to determine whether the privilege had been impliedly waived: (1) assertion of the privilege must be the result of an affirmative act – in other words, the privilege is implicated in the context of an affirmative defense; (2) as a result, the privileged information has been put at issue by the person asserting the privilege by making it relevant to the case; and (3) upholding the privilege would deny the opposing party access to information vital to his defense (sometimes termed a “sword and shield” approach). For a discussion of the “sword and shield” analysis, see *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992).

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<sup>2</sup> The other three approaches were: (1) the automatic waiver rule – whereby a party automatically waives the privilege by asserting a claim or defense to which otherwise privileged material is relevant; (2) a balancing test – weighing the need for discovery against the underlying rationale for the privilege; and (3) a more protective waive theory whereby the privilege is waived only if the party directly injects an attorney communication into issue.

## **G. Suggestions Regarding the Examination.**

### **1. Credibility -- There Is No Substitute.**

Establish your credibility with the examiner early. You are laying the groundwork for your reputation in the future. Treat the examiner like you would like to be treated yourself. Be reasonable on “procedure” but hard on the issues. Like you, the examiner has other cases and other deadlines. Work with the examiner to make the audit process as streamlined as possible. Establish reasonable deadlines for providing information to the examiner and meet those deadlines. If you or the taxpayer is unreasonable regarding procedural matters, you will send the impression to the examiner that there is something to hide.

### **2. Control the Time and Place of the Examination.**

The Internal Revenue Code does not mandate a particular time or place for the examination -- it simply must be “reasonable under the circumstances.” I.R.C. § 7605(a). Most examiners are not particular about the location for the examination, as long as it is convenient to all concerned.

(a) The taxpayer’s representative’s office is generally the best location. It is easier to maintain control of the examination if it is conducted in the office of the taxpayer’s representative. Copies of documents provided to the examiner should be Bates-labeled or otherwise marked to record to avoid any dispute over what documents you have provided. If there are any record retrieval or other problems that you can foresee, discuss those with the examiner.

(b) If the examiner has not told you the scope of the audit before the initial conference, ask the examiner if there are issues already identified.

### **3. Provide the Examiner with All Documents and Other Information Reasonably Requested on a Timely Basis.**

As discussed above, an examiner has broad authority to compel production of information that may be relevant or material to the examination of the return. If the taxpayer refuses or fails to furnish the examiner with the information requested, the examiner may issue a summons requiring the taxpayer or a third party to produce the requested information.

### **4. Preparation for the Personal Representative’s Interview.**

In many cases, the examiner will request that the personal representative be present at the initial interview even where the estate is represented by a practitioner. Taxpayer interviews can be dangerous if steps to prepare the taxpayer for the interview are not taken. Remember, an experienced examiner is an attorney who knows the right questions to ask. In most cases, the personal representative has never been through the audit process or had a deposition taken. Spend time with the personal representative in discussing the various areas of anticipated questioning so that the taxpayer will know what to expect. The personal representative should be counseled to provide complete and accurate information, but to avoid volunteering extraneous or irrelevant information. The interview should be cordial but

businesslike. The taxpayer's representative should not be shy during the interview and should step in when necessary to correct any inadvertent misstatements.

The "voluntary" interview does not generally carry the procedural protections inherent in an interview given in response to an administrative summons, where the interview is usually recorded, a transcript can be obtained, and a clear record of what was asked and said is made. The taxpayer, however, has the right to make an audio recording of an interview with an IRS collections or examination official. The taxpayer's request to record the interview must be made in writing, and must be received ten (10) days before the scheduled meeting. The taxpayer must bring his or her own recording equipment. The IRS also has the right to record the interview. The taxpayer can generally obtain a copy of the IRS's recording at the taxpayer's expense.

## **5. Statutes of Limitation.**

The three-year statute of limitations for an estate tax return begins running upon the filing of the estate tax return. No extension of the statute of limitations for an estate tax return is available. That is why the estate tax audit must be completed as a general rule within eighteen months of the time the return was filed. However, if false or fraudulent return has been filed with the intent to evade tax, the tax may be assessed at any time. I.R.C. § 6501(c)(1). If the estate tax return has omitted gross estate items which exceed in value 25% of the gross estate stated in the return, additional estate tax may be assessed within six years after the return was filed. I.R.C. § 6501(e)(2).

## **6. Negotiations?**

Estate tax attorneys generally cannot make agreements based upon the hazards of litigation. Only appeals officers and district counsel can make these types of concessions. The examiner's job is to raise issues, investigate the facts, apply the law, and make a recommendation as to the correct tax liability. Examiners do not have the authority to trade one issue for another. That is why, particularly with valuation disputes, the taxpayer is generally better served by taking the dispute to appeals or the district counsel level.

## **H. Concluding the Estate Tax Examination.**

At the conclusion of the examination, the examiner will discuss his or her findings with the taxpayer. If an agreement is obtained, the taxpayer will be requested to execute Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment Estate and Gift Tax, after all computations are adequately explained. The examiner will solicit payment for deficiencies if agreement is indicated.

If the taxpayer has disagreement with any of the proposed adjustments, the case will be processed in accordance with the unagreed case procedures.

Regardless of whether the case is agreed or unagreed, the examiner will prepare a report of his or her examination, and will generally provide it to the taxpayer or the taxpayer's representative. If the examiner does not volunteer to provide a copy to you, do not hesitate to ask for one. The examiner will generally provide it to you on request.

## **I. Procedural Options After Examination.**

### **1. File a Waiver.**

As noted above, the taxpayer could execute a Form 870 and agree to the assignment and payment of the tax. This approval is taken in cases where the taxpayer is particularly concerned about the running of statutory interest or any claimed deficiency (which starts to run nine months after the date of the decedent's death). Payment of the additional tax and accrued interest should be submitted to the IRS with the waiver. If the taxpayer chooses this option, the taxpayer may later request a refund. If the refund is disallowed, the taxpayer may file a refund suit in Federal District Court or United States Court of Claims. Executing the waiver, however, will preclude the taxpayer from filing a petition with the Tax Court, since the IRS will be authorized to assess the deficiency without sending a statutory notice of deficiency, receipt of which is a prerequisite to Tax Court jurisdiction.

### **2. Pursue Appeals by Filing a Written Protest with the IRS.**

If the taxpayer disagrees with the report enclosed with the 30-day letter (the "Revenue Agent's Report" or "RAR"), he may request an appeals conference with an IRS Regional Appeals Office. This is done by filing with the District Director a written protest contesting the proposed additional tax liability.

### **3. Wait to Receive a Deficiency Notice.**

If the taxpayer does not execute a waiver or file a protest, the taxpayer may wait to receive a statutory notice of deficiency (90-day letter) issued pursuant to I.R.C. 6212(a). A 90-day letter cannot be issued until the expiration of the initial 30-thirty day period, and no assessment or collection of the proposed deficiency can be made within that 30-day period. If no response is made to the 30-day letter, the 90-day letter will be issued by the District Director, and the content generally will be the same as the content of the 30-day letter. Once a 90-day letter is issued, the taxpayer may appeal directly to the courts as discussed below.

## **IV. APPEALS.**

### **A. The Mission of Appeals.**

The appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.

### **B. Filing the Protest Letter.**

An appeal from the RAR is initiated by filing a written protest with the District Director contesting the proposed additional estate tax liability. The protest must be filed within 30-days from the date of the 30-day letter, and if the proposed change to the tax is more than \$10,000 for any period, the protest must contain the following:

- (a) the taxpayer's name and address;
- (b) statement that the taxpayer wants to appeal the examination findings;
- (c) the date and symbols from the 30-day letter;
- (d) the tax period involved;
- (e) itemized schedule of the changes with which the taxpayer disagrees;
- (f) statement of facts supporting the taxpayer's position on any issue with which the taxpayer disagrees;
- (g) statement of the law or other authority on which the taxpayer relies; and
- (h) a declaration by the taxpayer or his representative in the form set forth in IRS Publication 5.

Use the RAR as the basis for preparing your protest letter. Clearly address the issues raised in the RAR and clearly set forth the facts and the law upon which you rely. The appeals officer must prepare a report justifying any proposed settlement to the chief or associate chief of appeals. If you provide a thorough discussion of the facts and the law supporting your position, and if the appeals officer agrees with your analysis, you will give the appeals officer the basic material and analysis needed to write that report and the chance is improved that the report will be accepted.

Address directly all of the factual and legal positions included in the RAR. Unless the appeals officer has raised facts or issues outside of the RAR with you, there is generally no need to address the factual legal issues the examiner did not raise. If you do not address all of the factual and legal issues raised by the examiner in the RAR, you will be suggesting to the appeals officer that those issues cannot be addressed. The protest should avoid personal attacks on the examiner. While such personal attacks might give you or your client some level of personal satisfaction, particularly where you feel the examiner has been unreasonable, they do not advance your client's position with the appeals officer. References to the positions taken by the examiner should be to the "RAR" with the "Examination Report" rather than the "Agent" or the "Examiner." Remember, treat IRS personnel as you would like to be treated yourself.

An Appeals officer reviews the case and has the authority to raise issues other than those considered at the district level. This is an important factor to consider because review by Appeals is likely to be more thorough and made by more experienced personnel. The IRS appellate procedures are outlined in Treas. Reg. § 601.106 *et seq.* If the period of limitations for an assessment is about to expire and the taxpayer refuses to agree to an extension (gift tax cases only, since the estate tax limitation period cannot be extended), or if no agreement is reached through the IRS appeals process, a statutory notice of deficiency (referred to as a "90-day letter")

will be issued by Appeals pursuant to I.R.C. § 6212(a). The taxpayer may pursue a remedy in the courts.

During the appeals process, interest continues to accrue on the proposed deficiency and no 90-day letter will be issued. Paying the proposed deficiency to stop interest from accruing creates a later problem, however, because payment of the proposed deficiency before a 90-day letter is issued deprives the Tax Court of jurisdiction (see below).

### **C. Jurisdiction of Appeals.**

Appeals has jurisdiction over a case in four different ways:

#### **1. Response to Protest of 30-day Letter.**

If a taxpayer files a response to a 30-day letter, Appeals may accept jurisdiction. However, Appeals will not accept the case with less than six months left on the statute of limitations. The examiner will issue a 90-day rather than a 30-day letter if there are less than nine months left on the three-year statute of limitations.

#### **2. Petition to Tax Court.**

If a taxpayer files a petition in the tax court in response to a 90-day letter and the case has not previously been to Appeals, district counsel will forward the case to Appeals for settlement discussions. Once the case is set for trial on the court's calendar, district counsel has responsibility for settlement discussions. However, the Appeals officer will often stay involved when doing so will help the settlement process.

#### **3. Protest of the Rejection of the Claim for Refund.**

If the taxpayer chooses to pay the assessed tax, the taxpayer has two years from the payment or three years from the date the return was filed, whichever is later, to file a claim for refund. If the claim for refund is disallowed, the taxpayer may file a protest and request that the protest be considered by Appeals.

#### **4. Appeal of Rejected Offer in Compromise Based on Dubious Liability.**

If the examiner disallows an offer in compromise filed under I.R.C. § 7122, a protest can be filed with Appeals.

### **D. Negotiating with Appeals.**

Appeals has initial authority to settle almost all issues before it without consultation with local district counsel. 26 C.F.R. § 601.106(a)(1)(i). The Appeals officer has sole jurisdiction in cases that have not yet been filed in the Tax Court, but Appeals officers may request district counsel attorneys to provide their view of the issues and the likely result of litigation. Unlike the estate tax examiner, Appeals officers can settle cases on the basis of "hazards of litigation."

When the case is in the Tax Court, and Appeals is involved (since the 90-day letter was sent before the case went to Appeals), Appeals has complete settlement authority until the case is calendared for trial. Once the case is calendared, it passes to district counsel for trial preparation. However, Appeals will keep a case to complete a settlement if an agreed resolution seems likely. Moreover, Appeals officers will generally stay in the loop to discuss settlement possibilities even after the trial of the estate tax controversy.

In civil litigation, settlement negotiations between the parties tend to focus on “how much will I have to pay?” or “how much will I receive?” Negotiations with the Appeals officer and district counsel generally take an “issue approach” rather than a “dollar basis.” Since Appeals officers and district counsel will be required to provide justification for any proposed settlement to their superiors, the questions are more issue based (*i.e.*, what is the likelihood of success of the taxpayer or the IRS on this particular issue?). Your settlement offers should be thought out on this basis. While the bottom line to your client is how much he or she will have to pay in taxes, creative settlement negotiations can reach this end result through the issue based approach.

## **V. LITIGATION.**

### **A. Proceedings in the Tax Court.**

The taxpayer has ninety days from date of the 90-day letter to file a petition with the Tax Court. If the proposed deficiency is paid before the 90-day letter is issued, the Tax Court will not have jurisdiction. If less than the entire proposed deficiency is paid before the 90-day letter is issued, a 90-day letter will be issued only for the balance of the deficiency. Rev. Proc. 63-11, 1963-1 CB 497. However, under I.R.C. § 6213(b)(4), payment of the proposed deficiency after issuance of a 90-day letter but before (or after) the filing of the petition will not deprive the Tax Court of jurisdiction. I.R.C. § 6213(b)(4).

The burden of proof in the Tax Court is on the taxpayer to show that the Commissioner’s determination and adjustments were erroneous. If, however, in its answer to the taxpayer’s petition, the IRS makes new allegations and seeks an increased deficiency (which it may do), it has the burden of proof as to those newly raised issues. T.C. R. 142 (a); *Ferguson v. Comm’r*, 47 T.C. 11 (1966). Under I.R.C. § 6673, the Tax Court may penalize the taxpayer in an amount up to \$25,000.00 if it finds a suit is groundless or frivolous or the taxpayer has unreasonably failed to pursue “administrative remedies.” I.R.C. § 6773(a). The taxpayer may appeal a decision of the Tax Court to the U.S. Court of Appeals as a matter of right.

### **B. Proceedings in the United States District Court or U.S. Court of Federal Claims.**

To bring a case before the U.S. District Court or U.S. Court of Federal Claims (the “Claims Court”), the taxpayer must pay the full amount of tax due and file a timely claim for a refund. Once the taxpayer files for a refund, he may file a suit in the district court after six months if the IRS has not acted on the refund claim. If the claim is disallowed within six months, the taxpayer has two years from the date of the disallowance to file suit.

In district court, either the government or the taxpayer may request a jury trial. A jury trial is not available in Claims Court, however. In a refund suit, the burden of proof is on the taxpayer to show: (1) that the tax was overpaid; and (2) the amount of the overpayment. The taxpayer may appeal the decision of a district court to a U.S. Court of Appeals as a matter of right. A Claims Court decision may be appealed only to the Court of Appeals for the Federal Circuit.

### **C. Deciding Which Forum to Choose.**

Each of the three choices of forum for the estate tax dispute has advantages and disadvantages.

#### **1. Payment of the Tax.**

To proceed in the Claims Court or the District Court, the taxpayer must pay the entire deficiency and file a claim for refund. The payment of the deficiency will obviously stop the accrual of interest on the deficiency. The taxpayer does not have to pay the tax before proceeding in the Tax Court. As noted above, however, the taxpayer may pay the deficiency after the 90-day letter is issued, stop the accrual of interest and still proceed in the Tax Court.

#### **2. Finder of Fact.**

In the Claims Court and the Tax Court, the ultimate finder of fact is the judge. If your case hinges on legal issues instead of factual issues, you might consider the Tax Court over the Claims Court or the District Court. Tax Court judges have a background in tax law and only hear the tax cases. District Court judges hear a broad range of diversity and federal question cases and may or may not have a background in tax law. Claims Court judgments may or may not have a background in tax law. A taxpayer has the right to a jury trial in the District Court. If you have a case to which a jury might be sympathetic, the District Court may be the better forum.

#### **3. Precedents.**

Before filing your case, determine whether the court or the court to where any appeal will be taken has unfavorable precedents. If, for example, the claims court has a case holding against your position but the Tax Court has a case holding in your favor, the Tax Court should be your forum of choice.

#### **4. Discovery.**

Discovery is much more limited in the Tax Court. *See* T.C.R. 70-91. Fact depositions are limited and experts are almost never deposed. Discovery in the Claims Court and District Court are similar to traditional civil litigation. If the taxpayer is concerned about discovery costs, the Tax Court is the preferred forum.

## **5. Opposing Counsel.**

Suits in the Tax Court are filed against the Commissioner of Internal Revenue. The Commissioner is usually represented by the IRS district counsel in the forum in which the suit was filed. Suits in the claims court and the district court are filed against the “United States of America.” In Claims Court cases, the government is generally represented by Justice Department, Tax Division, Court of Federal Claims Section. In District Court cases, the government is generally represented by Justice Department, Tax Division.

## **6. Location.**

Tax Court cases are generally tried in the city designated by the taxpayer. T.C.R. 140. A list of cities in which regular sessions of the Tax Court are held are listed in Appendix IV of the Tax Court Rules. If the taxpayer fails to designate a place of trial, the I.R.S. shall designate a place of trial preferred by the Commission. *Id.* Claims Court cases are tried in Washington, D.C. District Court cases must be filed and tried in the district where the taxpayer resides; if a decedent, where the decedent resided at his or her death.

### **D. Ask for an Early Trial Date.**

Strategically, it often is in the taxpayer’s interest to pursue an early trial date, assuming that the taxpayer and his experts are ready for trial. This is especially true in valuation cases. If a taxpayer has a competent appraisal in support of the transaction at issue, setting an early trial date will force the IRS to focus its efforts on the case. Many times the IRS will not yet have secured an appraisal and would not be ready for trial. Crystallizing the case for the IRS in this manner often can lead to a settlement favorable to the taxpayer.