

Tax Litigation Issues

By John W. Porter

The Transfer Tax Audit—The Beginning of the Litigation Discovery Process

As the IRS's scrutiny of family limited partnerships and limited liability companies has increased over the last few years, the IRS has significantly stepped up its estate and gift tax audit efforts. Increased pressure is being placed on examining agents to fully develop the case at the audit level in a timely manner. The IRS's audit efforts include substantial requests for the production of documents, written questions designed to elicit the purposes for the creation of the entity and requests for interviews with the taxpayer and persons involved in creating and operating the entity.

The taxpayer's responses to these information requests can have a significant impact on the outcome of the audit and any future estate and gift tax litigation. As the Seventh Circuit has articulated,¹ the audit level is the "antechamber" to litigation. It is the time when much of the IRS's "pre-trial" discovery occurs. In several of my recent cases, most of the IRS's discovery was conducted at the audit level, with little discovery being sought by IRS District Counsel at the trial court level. Many planners ask when is the appropriate time to bring in the trial lawyer who will handle any litigation with the IRS. In my view, the audit level is the latest stage at which the trial lawyer should become involved.

Common IRS Document Requests

The audit often begins with a broad request for the production of documents. Typical information requests from the IRS in estate and gift tax audits involving limited partnerships and LLCs include the following:

- All tax and nontax reasons the decedent indicated for the formation of the partnership
- The names, addresses and telephone numbers of



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John W. Porter is a Partner in the law firm of Baker Botts, LLP. A nationally recognized tax litigator, John is the former Co-Chair of the Tax Litigation and Controversy Committee of the American Bar Association's Real Property, Probate and Trust Section. He is also a Fellow of the American College of Trust and Estate Council.

all individuals who have personal knowledge of the reasons for forming the partnership, including those who were present when the reasons were given or discussed

- All tangible evidence that exists that corroborates the reasons for forming the partnership
- All documents prepared in connection with the decision to form the partnership, or which reveal the purposes or motivations for forming the partnership
- Any legal, accounting or other bills for services rendered in connection with the formation of the partnership
- A list of all of the decedent's assets and their values and income generated therefrom as of the date of formation of the partnership which were not contributed to the partnership, supported by tangible evidence (e.g., deeds, bank statements, money market statements, etc.)
- A description of the decedent's medical condition, including any life threatening conditions and medical treatments thereof
- All names, addresses and telephone numbers of all physicians that were treating the decedent for any of the foregoing conditions
- Written permission to provide the decedent's medical records and information to the IRS and provide copies of these authorizations to my attention at our initial meeting
- The partnership account statements and checks (including all statements indicating where partnership assets were held (i.e., cash, securities, etc.)
- All records of ownership, acquisition and transfer from the inception of the partnership through the present date

As you can see, the inquiries relate primarily to (1) why the entity was created, (2) the senior family member's health at the time the entity was created, and (3) how the entity was operated.

What Documents Should Be Produced?

In responding to an audit inquiry, the first question often asked is how broad is the taxpayer's obligation to produce documents? A related inquiry is whether the taxpayer must produce documents in the hands of third parties. As a general rule, the taxpayer has the obligation to produce any requested relevant documents within his "possession, custody or con-

trol." Possession, custody or control is a fairly broad concept, and includes not only the documents possessed by the taxpayer, but those possessed by agents of the taxpayer. Examples of such agents include attorneys, accountants, financial planners and stockbrokers.

Dealing with Privileged Communications

A second consideration in responding to an audit inquiry is whether any of the information requested is privileged from disclosure. Privileges that may apply include the attorney-client privilege, the attorney work product privilege and the tax practitioner's privilege. For example, communications between a client and her lawyer regarding the creation of the partnership will likely fall within the attorney-client privilege. Communications regarding audit issues between the taxpayer and the client will likely be protected from discovery under both the attorney-client privilege and the attorney work product privilege. Interestingly, no federal doctor/patient privilege exists, so medical records would not generally be protected from discovery.²

If a privilege exists with respect to certain communications, the taxpayer³ will have to decide whether to waive or to assert the privilege. As a general rule, a client cannot waive the privilege with respect to some communications regarding the subject matter without waiving the privilege as to others. For example, the client cannot produce a privileged letter from her attorney that is helpful to her case but assert the attorney-client privilege with respect to other communications with the lawyer involving the same subject matter. Thus, the decision of whether to waive or to assert the privilege is complex, and can have a significant impact on the outcome of litigation. There is no one right answer—the decision must be made on a case-by-case basis.

An important factor to consider in asserting or waiving the privilege is whether the person involved in the privileged communication will be needed to testify at trial with respect to privileged communications that could ultimately be used to support the taxpayer's position. This is especially important where the client is deceased and the lawyer's testimony is necessary to support a critical element of the taxpayer's case. In *C.P. Schutt*, the decedent's estate planning attorney testified at trial with respect to the reasons for

creating the Delaware Business Trusts at issue. The lawyer's oral and written communications with his client (which were subject to the attorney-client privilege) as well as the communications with third parties were found by the Tax Court to be persuasive evidence supporting the court's finding that the *bona fide* sale exception to Code Sec. 2036 applied.⁴

Effects of the Failure to Cooperate

The examining agent will typically request that the response to information requests be provided within 30 days. Examining agents commonly grant reasonable extensions, particularly where a substantial information request has been made. In recent months, however, the IRS has become more aggressive in pursuing the information requested through the use of its summons powers granted in the Internal Revenue Code. The taxpayer needs to be aware that if the information sought is not voluntarily produced in a timely fashion, the IRS may issue a summons to obtain it.

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 to (1) examine any books, papers, records or other data that may be relevant or material to such inquiry, and (2) 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.⁵

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 e-mails).

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's possession; and (4) satisfies all administrative steps required by the U.S. Code.⁶ However, the IRS's broad summons power remains subject to traditional privileges and limitations.⁷ 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.

Failure to timely produce information at the audit level can also have serious implications as the case proceeds to trial. 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.⁸ 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 fails to reasonably cooperate with the IRS at the audit level, it is a reasonable assumption that the court will not shift the burden of proof from the IRS to the taxpayer under Code Sec. 7491.

Conclusion

Given the focus of the IRS's requests for information in these types of cases (why the entity was created and how it was operated), there is no doubt that planning for the transfer tax dispute begins at the estate planning level. Care should be taken to document the nontax reasons for creating the entity, and making sure all of the i's are dotted and t's are crossed. Likewise, as the IRS steps up its transfer tax audit efforts with respect to limited partnerships and similar entities, counsel should recognize that discovery responses provided during the audit can have the same impact as responses provided to formal discovery requests in the trial court. Attorneys who are not experienced in handling litigation matters or pretrial discovery should strongly consider consulting with litigation counsel at this stage. As the old saying goes, an ounce of prevention is worth a pound of cure.

ENDNOTES

- ¹ See *R.A. Frederick*, CA-7, 99-1 USTC ¶50,465, 182 F3d 496.
- ² See *Jaffee v. Redmond*, SCt, 518 US 1, 116 SCt 1923 (1996); FED. R. EVID. 501.
- ³ For decedent's estates, the privilege is held by the personal representative of the estate. *Swidler & Berlin and James Hamilton*, SCt, 524 US 399, 118 SCt 2081 (1998).
- ⁴ See *C.P. Schutt Est.*, 89 TCM 1353, Dec. 56,042(M), TC Memo. 2005-126.
- ⁵ Code Sec. 7602(a).
- ⁶ *M. Powell*, SCt, 64-2 USTC ¶9858, 379 US 48, 57-8, 85 SCt 248.
- ⁷ *H.F. Euge*, SCt, 80-1 USTC ¶9222, 444 US 707, 714, 100 SCt 874.
- ⁸ Code Sec. 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.

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