Volume XXXIV
Issue 1
Winter 2008

MICHIGAN TAX LAWYER

SBM State Bar of Michigan
Taxation Section

CONTENTS

The MICHIGAN TAX LAWYER is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The MICHIGAN TAX LAWYER is published three times each year - September (Fall), January (Winter) and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Lynn A. Gandhi, LGandhil@honigman.com; 660 Woodward Avenue, 2290 First National Building, Detroit, MI 48226-3506

LYNN A. GANDHI
Editor

MARJORIE B. GELL
Assistant Editor

PUBLICATION COMMITTEE
LYNN A. GANDHI and MARJORIE B. GELL

STATE BAR OF MICHIGAN TAXATION SELECTION COUNCIL

JAY A. KENNEDY
Chairperson

JESS A. BAHS
Vice Chairperson

RONALD J. CHARLEBOIS
Treasurer

GINA M. TORIELLI
Secretary

AARON H. SHERBIN
Ex-Officio

Joan R. Dindoffer
John M. O'Hara
Marjorie B. Gell

Frederick H. Hoops II
David B. Walters
Wayne D. Roberts

Michael W. Domanski
Lynn A. Gandhi
Warren J. Widmayer

PROGRAM FACILITATOR
Deborah L. Michaelian

PROBATE SECTION LIAISON
Lorraine New

I.R.S. DISTRICT COUNSEL
Robert D. Heitmeyer

SUBSCRIPTION INFORMATION

Any member of the State Bar of Michigan may become a member of the Section and receive the MICHIGAN TAX LAWYER by sending a membership request and annual dues of $30 to the Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933-2083. In addition, any person who is not eligible to become a member of the State Bar of Michigan, and any institution, may obtain an annual subscription to the MICHIGAN TAX LAWYER by sending a request and a $33 annual fee to the Taxation Section at the aforementioned address.

CHANGE OF ADDRESS

Individual subscribers should send notification in writing to: MICHIGAN TAX LAWYER, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, MI 48904.

Citation Form

The MICHIGAN TAX LAWYER may be cited as follows: (Vol.) (Issue) MI Tax L. (Page) (Yr.).

Disclaimer

The opinions expressed herein are those of the authors exclusively and do not necessarily reflect those of the Publication Committee, the Taxation Section Council or the Taxation Section. It is the responsibility of the individual lawyer to determine if advice or comments in an article are appropriate or relevant in a given situation. The Publication Committee, the Taxation Section Council and the Taxation Section disclaim all liability resulting from statements and opinions contained in the MICHIGAN TAX LAWYER.

SBM STATE BAR OF MICHIGAN

p (517) 346-6300
p (800) 968-1442
f (517) 482-6248

Michael Frank Building
306 Townsend Street
Lansing, MI 48933-2083

www.michiganbar.org

Taxation Section

PROGRAM FACILITATOR
DEBORAH L. MICHAELIAN
39500 HIGH POINTE BLVD.
SUITE 350
NOVI, MI 48375
(248) 567-7423
dlmichaelian@varnumlaw.com

CHAIR
AARON H. SHERBIN
(248) 351-3000
asherbin@jaffelaw.com

VICE CHAIR
JAY A. KENNEDY
(313) 566-2500
jakennedy@anqey.com

TREASURER
JESS A. BAHS
(248) 723-0495
jbahs@howardandhoward.com

SECRETARY
RONALD T. CHARLEBOIS
(248) 283-2017
rcharlebois@powerschapman.com

COUNCIL
JOAN R. DINDOFFER
(313) 222-9386
joan_r_dindoffer@comerica.com
MICHAEL W. DOMANSKI
(313) 465-7352
mdomanski@honigman.com
MARJORIE B. GELL
(616) 632-8023
mgell@mmbjlaw.com
FREDERICK H. HOOPS III
(313) 965-8323
fhoops@clarkhill.com
PAUL R. JACKSON
(231) 727-2626
pjackson@wnj.com
WAYNE D. ROBERTS
(616) 776-7514
wroberts@dykema.com
ALVIN L. STORRS
(517) 432-6800
storrs@law.msu.edu
GINA M. TORIELLI
(248) 370-3625
toriellg@cooley.edu
WARREN J. WIDMAYER
(734) 662-0222
warren@fw-pc.com

EX OFFICIO
CHARLES M. LAX
(248) 827-1877
cml@maddinhauser.com

COMMITTEE CHAIRPERSONS

BUSINESS ENTITIES
JOHN M. O'HARA
(248) 539-2255
john_ohara@edwardrose.com
EMPLOYEE BENEFITS
DAVID B. WALTERS
(248) 743-6052
dwalters@bodmanllp.com
ESTATES AND TRUSTS
DOUGLAS W. STEIN
(313) 596-9320
dstein@bsdd.com
PRACTICE AND PROCEDURE
JOSEPH PIA
(248) 646-8292
jpia@hymanlippitt.com
STATE AND LOCAL
PAUL V. McCORD
(248) 567-7414
pvmccord@varnumlaw.com

September 19, 2007

Section Members:

I never would have imagined some 11 years ago, when I was asked and accepted to serve as chair of the Practice and Procedure Committee of the Taxation Section, that I would be before you today as the Section's Chairperson. I have learned so much and developed wonderful relationships over the past 11 years. Today, I am filled with mixed emotions.

When I took over as Chairperson last year, I was handed a Section that was fiscally sound, well-organized, efficiently run and supported by a large and diverse membership--the result of hard work and dedication of chairpersons and council members before me. My pledge and promise to the Section last year, when I accepted the gavel, was to continue moving the Section in the right direction and to continue to improve upon education and outreach.

I am pleased to say that we have achieved these objectives and much more. The following is my annual report for the 2006-2007 year of the State Bar of Michigan Taxation Section:

Committee Activities:

The Taxation Section has five active Committees. Each Committee periodically meets throughout the year, providing practitioners an excellent way to interact with their peers who practice in a particular subspecialty of tax law. Our Committees include Business Entities, Employee Benefits, Estates and Trusts, Practice and Procedure and State and Local Taxation. Not only do the subcommittees provide valuable educational opportunities to the membership, but they also serve as a training ground for the future leadership of the Section. Each of this year's chairs offered programs and speakers that were educational and informative and had great appeal to our members. The committees continued to have strong attendance at meetings and continued to foster camaraderie among practitioners. I'm excited to report that the Section is exploring the idea of re-establishing an International Tax Subcommittee. With the help of Mike Domanski and others, our Section will be sponsoring programs and events for lawyers practicing in the area of international tax with the hope of gaining enough support and interest to establish an International Tax Subcommittee. I would like to thank the chairpersons of each of the Committees for all of their hard work and commitment this past year. My thanks to David Walters as chair of the Employee Benefits Committee, Doug Stein as chair of the Estates and Trust Committee, Paul McCord as chair of the State and Local Tax Committee, Joseph Pia as chair of the Practice and Procedure Committee and John O'Hara as chair of the Business Entities Committee.

PAST COUNCIL CHAIRS

JOSEPH A. BONVENTRE
ALLAN J. CLAYPOOL
STEPHEN H. CLINK
JOHN J. COLLINS, JR.
ROGER COOK
EDWARD M. DERON
CLIFFORD H. DOMKE
J. BRUCE DONALDSON
OSCAR H. FELDMAN
STEPHEN M. FELDMAN
EUGENE A. GARGARO, JR.
ERNEST GETZ
GEORGE W. GREGORY
JOSEPH D. HARTWIG
STEPHEN I. JURMU
CAROL J. KARR
LOUIS W. KASISCHKE
JOHN L. KING
DONALD M. LANSKY
JEFFREY A. LEVINE
ARNOLD W. LUNGERSHAUSEN
JERRY D. LUPTAK
JOHN W. McNEIL
JACK E. MITCHELL
DENNIS M. MITZEL
J. LEE MURPHY
LAWRENCE J. MURPHY
ERIC M. NEMETH
REGINALD J. NIZOL
JAMES H. NOVIS
ROBERT B. PIERCE
B. COURTNEY RANKIN
JOHN J. RAYMOND, SR.
DAVID M. ROSENBERGER
ANDREW M. SAVEL
BENJAMIN O. SCHWENDENER, JR.
JOHN N. SEAMAN
PETER S. SHELDON
SHERILL SIEBERT
WILLIAM J. SIKKENGA
I. JOHN SNIDER II
ROBERT R. STEAD
LAWRENCE R. VANTIL
ERIC T. WEISS

Tax Conference:

Our annual tax conference was held on May 2, 2007 at the Inn at St. Johns, Plymouth, Michigan. It is our biggest and most important event of the year. Once again, the conference was strongly attended and offered a very comprehensive and up-to-date program on the very latest and most important topics in the area of tax law. We were fortunate to have nationally recognized speakers, presenters from the United State Department of Labor, from the Internal Revenue Service, from the Michigan Legislature and local practitioners who are recognized by their peers as experts in their field of tax law. Of course, the success of the conference could not have been made possible without the generous financial support from our sponsors. I would like to thank LaSalle Bank, Stout, Risius and Ross and Bernstein Global Wealth Management for their support and sponsorship of this year's conference. I would also like to thank and recognize Warren Widmayer, the chairperson of the 2007 conference, who worked tirelessly and was instrumental in the success of this year's conference.

After Hours Tax Series:

The Section spends a considerable amount of resources and time providing our members with the most current and up-to-date information in the area of tax law. The practice of tax law has become increasingly complex and constantly changing. For those of you with an active practice, you know how difficult it is to stay current. In an effort to keep members up-to-date, we sponsors, along with the Institute of Continue Legal Education (ICLE), an After Hours Tax Law Series which offers lectures on a wide variety of tax topics. Once again, the Taxation Section, through the After Hours Tax Series, was able to provide the members with programs on tax topics of interest. These programs were very popular and well attended. My thanks to Alvin Storrs, who continued to oversee these programs and liaison with Mary Heniker of ICLE, our co-sponsor.

Tax Lawyer:

This year the Section published three (3) editions of the Michigan Tax Lawyer. These periodicals contain articles providing in-depth analysis and advice on tax issues. The Michigan Tax Lawyer possesses a national reputation for its excellence. It is recognized by the members of the National Association of State Bar Tax Sections as one of the preeminent journals published by any tax section in the nation. During the upcoming year, the Section will consider disseminating the Michigan Tax Lawyer via the Internet. The Section recognizes the increased importance and reliance on the Internet by attorneys and the tremendous cost savings from going "paperless". Once again, Marjorie Gell served as editor of the Michigan Tax Lawyer. She has worked extremely hard in improving the journal in all aspects - from its look to its content and from publishing to distribution. Marjorie is to be commended for continuing to improve the journal and I thank her for her great work.

Membership and Outreach:

In addition to providing our members with the best and most up-to-date education, the Section considers outreach a high priority and important objective. Not only are we continually trying to recruit attorneys to join our Section, but the Taxation Section has invested a considerable amount of time and resources to cultivate law students who have expressed an interest in tax law. I am particularly proud of the Council's efforts in outreaching to young lawyers and law students. Throughout the year, we have held meet and greet receptions at various law schools in the state of Michigan. These receptions have allowed Council members to meet one on one with law students and answer their questions about the practice of law and about employment opportunities in the area of tax law. The Section also provides law students with scholarships to attend our programs and events at a reduced rate. These scholarships have produced significant results. We had an overwhelming response of law students attend our annual tax conference, our tax court luncheon and our various committee meetings. The Section also provides law students with the opportunity to contribute articles to our Michigan Tax Lawyer. All of these efforts have helped to create interest in our Section by new lawyers. Overseeing the membership and outreach programs was Michael Domanski. I want to thank and congratulate Mike for all of his good work and all that he has accomplished this year.

Grant Program:

This year, the Section continued and improved upon its grant program. This was a program that we began last year to provide grants to low-income tax clinics who help under-represented taxpayers. This year we increased the amount of grants awarded to $10,000. During the tax conference, we recognized this year's grant award recipients: Accounting Aid Society, Legal Aid And Defender Association, Inc., The Baxter Community Center, Michigan Poverty Law Program, MSU College of Law Low-Income Taxpayer Clinic, and University of Michigan Low-Income Taxpayer Clinic. We are proud to sponsor and applaud the services provided by these organizations. I want to thank Jay Kennedy and the rest of the members of the Grant Committee for their work on this year's grant program.

Internet:

An important aspect of bringing value to our membership and reaching out to tax lawyers was to improve the content of the Taxation Section's website. This past year, through the efforts of Gina Torielli, our website was enhanced. Our directory, the journal and employment opportunity listings have all been made available to our membership. The website also contains seminar and conference materials and links to other valuable sites and resources for tax lawyers. I would like to thank Gina for her work on our Internet site and want to also extend my congratulations to her on her election as an officer of the Tax Section for the 2007-2008 year.

Michigan Bar Journal Liaison and Annual Meeting/Past Chairpersons Dinner:

Last year, Paul Jackson was recognized as the counsel's "utility player", a player who can play many positions. Once again this year, Paul was the counsel's utility player, having responsibility for a number of different matters. He served as the Michigan Bar Journal liaison, making sure we had a section brief in each edition and coordinating the submission of articles for the Michigan Bar Journal's tax edition. Paul was also in charge of putting together this year's Annual Meeting and Past Chairperson's Dinner. Paul I appreciate all of your hard work this year.

Tax Court Luncheons:

The Taxation Section hosted a Tax Court Luncheon on March 28, 2007, giving members an opportunity to meet United States Tax Court Judge Juan Vasquez. The Section will also be hosting another Tax Court Luncheon on October 30, 2007 with United States Tax Court Judge Carolyn Chiechi as our guest. Many thanks to Joan Dindoffer who organized our Tax Court Luncheons.

Federal and State Legislation/Public Policy Liaison:

The responsibility for reporting to tax Council any new developments concerning federal and state legislation and regulatory activities was vested in Wayne Roberts. Not only did Wayne do a fine job in keeping the Council updated and informed, he has also been instrumental in representing the Taxation Section as a partner of the upcoming Michigan Tax Conference. This promises to be Michigan's premiere event for the latest and greatest on state and local tax issues. It is anticipated that it will have attendees from around the Midwest. The recognition and exposure from being a partner in this event is yet another example of how our Taxation Section sets itself apart from other state taxation sections.

IRS Counsel Liaison:

The Taxation Section has always enjoyed a good working relationship with the local office of the Internal Revenue Service. Beginning last year, the counsel formalized a liaison relationship with the Chief Counsel's Office of the IRS. While the IRS has always been generous and helpful in assisting us with programming, this new relationship has given the tax bar access to our counterparts within the IRS and has fostered a better understanding of our roles and responsibilities. My thanks to both Robert Heitmeyer and Eric Skinner who have served as IRS liaisons to the Council.

Next, I would like to thank and express my sincere gratitude to Ron Charlebois, Council secretary, Jess Bahs, Council treasurer and Jay Kennedy, Council vice chairperson. Each of you is to be commended for your hard work and dedicated leadership. The Section should feel comfortable and secure in knowing that the Taxation Section remains in the capable hands of Jay, Jess and Ron.

Finally, I would like to give a special thanks to three friends and colleagues of mine. First, I would like to thank Chuck Lax. I took over as Chairperson of the Taxation Section from Chuck last year. Over the last two years, Chuck has been a mentor and advisor, providing me assistance and input whenever I called upon him. I would also like to thank Eric Nemeth. Although Eric is no longer a part of Council, Eric recruited me to join Council some 11 years ago. During those 11 years, Eric and I have shared many of the same positions and experiences on Council and shared our thoughts on the practice of law and family life. Thank you Eric for your guidance, support and friendship over the years. Last and certainly not least, I want to thank Deb Michaelian, our Section's Program Facilitator. There was nothing that I did as Chairperson without the input and assistance of Deb. Deb is hard-working, proactive and committed to the success of the Taxation Section. She also approaches the job with a great sense of humor and made it such a pleasure to work with her. I will really miss working with Deb.

In conclusion, I want to share a bit of interesting information with you. Each year, a representative of our Tax Council attends the National Association of State Bar Taxation Sections. This is an annual conference where representatives of each of the state's tax sections meet to discuss the administration and operation of their respective tax sections. I had the pleasure of attending this conference two years ago. It was at this conference that I realized how innovative and progressive our Taxation Section is as compared to taxation sections around the country. The State Bar of Michigan's Taxation Section serves as the model by which other sections measure themselves. Other states are extremely impressed by the sophistication of our Michigan Tax Lawyer, the depth and amount of educational programming we provide, the dedication and effort we give to outreach and the commitment we have made to the under-represented taxpayers through our grant program. As members of the Taxation Section, you should be proud of what the Section has accomplished and the national reputation and recognition it has received and enjoys.

It was an honor for me to serve as the sections' Chairperson this year. Thank you.

Very truly yours,

Aaron H. Sherbin
Chairperson

REPORT OF THE BUSINESS ENTITIES COMMITTEE

John M. O'Hara, Chairperson
Edward Rose & Sons
30057 Orchard Lake Road
Suite 100
Farmington Hills, MI 48334
(248) 539-2255 Phone
(248) 539-2125 Fax
john_ohara@edwardrose.com

RECENT ACTIVITIES

I have completed my two year term and want to announce that a new Chairman of the Business Entities Committee has been selected! He is Marko J. Belej of Jaffe Raitt Heuer & Weiss. Members of the Committee will be hearing from Marko in the near future and I wanted to inform you of this change. The contact information for Marko is mbelej@jaffelaw.com. The phone number is 248-351-3000. I will still be involved with the Tax Section as a Council member. My responsibilities will be as a Liaison to the Bar Journal and working on the AFTER HOURS TAX LAW SERIES. I have enjoyed my association with this Committee and hope you continue your participation with not only the Committee but the Section at large.

UPCOMING EVENTS

Nothing scheduled at this time.

If you would like to receive notices pertaining to future activities of the Business Entities Committee please provide Marko J. Belej with your email address and phone number.

REPORT OF THE EMPLOYEE BENEFIT COMMITTEE

Lisa B. Zimmer, Chairperson
Honigman Miller Schwartz and Cohn LLP
2290 First National Building
660 Woodward Avenue
Detroit, MI 48226-3583
Office: (313) 465-7614
Fax: (313) 465-7615
lzimmer@honigman.com

RECENT ACTIVITIES

On November 27, 2007, the committee held its annual joint meeting and dinner with the Michigan Employee Benefits Conference at Red Run Golf Club. The speaker was Mr. William Sweetnam of the Groom Law Group. Before joining Groom, Mr. Sweetnam was the benefits Tax Council in the Office of the Tax Policy at the U.S. Department of Treasury. Mr. Sweetnam discussed the new cafeteria plan regulations.

UPCOMING EVENTS

Nothing scheduled at this time.

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

Paul V. McCord, Chairperson
Varnum, Riddering, Schmidt & Howlett, LLP
39500 High Pointe Blvd.
Suite 350
Novi, MI 48375
(248) 567-7414 Phone
(248) 567-7440 Fax
pvmccord@varnumlaw.com

RECENT ACTIVITIES

The last meeting of the State and Local Tax Committee was held on October 9th 2007 and involved a formal presentation by John Neberle of Varnum Riddering, Glenn R. White of the Michigan Department of Treasury and my self regarding the new Michigan Business Tax. The presentation can be viewed at www.icle.org/michlaw/mbt/. On November 7 and 8, 2008 the Tax Section along with the MACPA and the Michigan Department of Treasury put on the first Michigan Tax Conference that drew 580 attendees. Committee member have been monitoring the recent changes to the MBT as a result of the repeal of the Service Use Tax and recent administrative guidance from Treasury, including RABs 2007-5 and 2007-6. On February 7, 2007 the Committee, in conjunction with ICLE will be putting on an ICLE program "Examining the Michigan Business Tax: Seeing the Forest Through the Trees".

UPCOMING EVENTS

The Committee next meeting is scheduled for February 5, 2008 at Dykema Gossett's Bloomfield Hills office located at 39577 Woodward Ave., Suite 300, Bloomfield Hills, MI. Michael R. Lohmeier of Virchow, Krause & Company, LLP will discussed USPAP issues that every lawyer trying a property tax case should know.

A question and answer session with representatives of the Michigan Department of Treasury is being scheduled for March 20, 2007.

REPORT OF THE PROBATE SECTION LIAISON

Lorraine F. New
Lorraine F. New PLLC
401 S. Old Woodward Suite 456
Birmingham, MI 48009
(248) 644-6400 Phone
(248) 646-7082 Fax
Lorraine.New@lorrainenew.com

Recent Activities

As recently appointed liaison between the Probate and Taxation sections, I have been sharing news of activities of one section to the other. The Probate section is deeply involved in drafting a Michigan Uniform Trust Code, which it hopes to complete by spring. In addition, it has subcommittees considering a Michigan Durable Power of Attorney Act and a Probate and Estate Tax Specialization. A Joint Committee of Taxation and Probate sections has been formed to consider modifications of the Michigan Business Tax which currently impact estates, trusts, family limited partnerships and limited liability companies.

Upcoming Events

Nothing scheduled at this time.

UPDATE ON PATENTING OF TAX STRATEGIES

Jay A. Kennedy, Esq.

The last issue of the *Michigan Tax Lawyer* included my article that highlighted problems with patenting of tax strategies. These patents are arguably business method patents qualifying for patent protection under current law. The U.S. House of Representatives responded to the significant concerns with these patents in H.R. 1908, the *Patent Reform Act of 2007*. Section 10 of this comprehensive legislation provides that a patent may not be obtained for a "tax planning method." This legislation defines "tax planning method" as "*a plan, strategy, technique or scheme that is designed to reduce, minimize, defer, or has, when implemented, the effect of reducing, minimizing, or deferring, a taxpayer's tax liability, but does not include the use of tax preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns." The Patent Reform Act of 2007* was passed by the House of Representatives on September 7, 2007 and placed on the Senate Legislative Calendar on September 11, 2007. Tax practitioners concerned with these issues should take steps to encourage Senate passage of Section 10 of this legislation.

In another development, the IRS issued proposed regulations on September 25, 2007 that would add patented transactions as a new category of "reportable transactions". The proposed regulations would affect taxpayers participating in reportable transactions under Code Sec. 6011, material advisors responsible for disclosing reportable transactions under Code Sec. 6111 and material advisors responsible for keeping lists under Code Sec. 6112.

HOW DID WE GET IN THIS MESS AND, MORE IMPORTANTLY, HOW DO WE GET OUT OF IT?

Michael J. Mulcahy

In the summer of 2001, the National Treasury was in a sense of great euphoria over the budget surpluses that had been rolling in for the last several years. And with that premise in mind, and several other factors, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001. The law provided, among other things, for an across the board relief from many different types of Federal levies, including the estate tax. Those of us who have been in this field for a number of years can go back and relate to the time frame when the exemption level and the filing requirement level was a mere $60,000. Anyone with a modest bank account, a brokerage account and a house with a mortgage paid off would have a taxable estate and without the benefit of the surviving spouse would incur tax liability at death. While the rates in those years was somewhat modest, it certainly did not sit well with most families and practitioners that the Federal government would put yet another burden on families in light of the rather high marginal income tax rates that seem rather onerous to all but the most fervent IRS agents.

Buried in the middle of this 144 page document were the relief provisions for decedents' estates. Not only did this Act reduce the top estate tax rates from the 55% rate effective in 2001 down to 45% for the years after 2006, it also provided significant relief in the form of the exclusion levels. For the year 2000, the exclusion level, that level below which a return is required, was at $675,000. The Act provided the gradual increase of this amount from the $675,000 level in 2001 to $1,000,000 in 2002 and 2003 and all the way up to $3,500,000 for the year 2009. In 2010, the fun really begins. According to the statute, the estate tax is completely repealed for decedent's who die in 2010 but and it is a significant but, the law is reinstated to its 2002 / 2003 levels in the year 2011.

During this rapid rise of the estate tax exclusion amounts, the gift tax level of $1,000,000 was not changed. The annual gift tax exclusions have been adjusted for inflation but that is certainly small compared to the relief given on the estate tax side.

Most estate planners were somewhat aghast at their first exposure to the statute and I am certain their heartbeat did not return to normal for a number of days, especially after trying to put their arms around the 2010 repeal and the 2011 restatement.

Since 1977, the estate tax provisions have undergone major changes. One of the great changes in the estate tax law was the introduction of the unlimited marital deduction in the early 1980s. This moved the estate planners from the longtime limitation of one-half of the adjusted gross estate to now allowing the planners to completely avoid transfer taxes on the death of the first spouse so long as the requisite form was filed and all of the statutory provisions followed. However, the 2001 statutory changes were filed more like a nightmare than relief provisions for most of the estate planners. While the relief granted was substantial and by-and-large well received by the tax professionals, it certainly represented some obstacles in the form of clear and concise, and more importantly, consistent drafting of estate planning documents. The most repeated refrain was how in the world can one draft a will and a trust if there is no estate tax and have the same document function as intended by the grantor when the estate tax is restored at the same level as existed 10 years earlier. There had been many solutions offered to this dilemma but I have yet to hear one that I believe is totally without flaws.

The point of this article is not to suggest the best ways to address this problem but simply to point out the folly of the Congressional tax writers and how this night-to-day-to-night change is going to alter not only the planning by tax professionals but how the Internal Revenue Service is going to address these issues as they attempt to establish audit plans and service center procedures for 2009 and beyond.

The majority of tax planners simply chuckled and found these provisions somewhat amusing until it became abundantly clear that the current Congress and the President either could not or would not address this apparent untenable position with the current statute in place. The several attempts to completely eliminate the estate tax for the years after 2009 have failed, certainly not from lack of trying, but have failed simply because the $22.0 billion hole in the Federal budget could not have been plugged without the tax panhandling at the feet of the voting public. Without the political stomach to shift this tax burden elsewhere, Congress has done what Congress does best -- nothing.

There seems to be little likelihood, and I am probably overstating this, that Congress and the President will be able to address any changes in the estate tax law before the change of Administrations in January of 2009. If we move our calendar ahead to February of 2009, when the real work might begin, we will have a new Congress and a new President that must address this provision and must address it quickly. If the law remains unchanged during that first six or seven months of 2009, I suspect that every estate planner in the country and the would-be estate planners will be deluged with requests and demands by their clients that new wills and trust provisions be put in place just in case the law is not changed. Most clients would certainly look upon this as an opportunity that should not be missed. Do we redo all of our documents to reflect the lack of an estate tax in the year 2010 or do we simply let the documents in place ride through this time period hoping, praying, that the death of the principal does not occur in 2010. Needless to say, there are certain liability issues if one were to do this but does that really mean that we have to redraft all of our documents for 2010? How long can we wait before we put these changes in place? I cannot answer those questions and I am not sure than anyone could at this point.

The Internal Revenue Service, where I spent in excess of 30 years attempting to discern the true mission of the Service, has also struggled with the Economic Growth and Tax Relief Reconciliation Act of 2001. From the heydays of the $60,000 exemption, where there was as many as 35 enforcement attorneys assigned to the Estate & Gift Tax Groups, to the present time where the numbers have dwindled to less than a handful, their mission has remained the same. No, it is not to squeeze as much tax out of estates as they possibly can, their mission is to administer the tax laws fairly for everyone and to collect the appropriate amount of tax. If you do not believe that is true, you can read their mission statement that is on display in the lobby of most IRS offices.

As you can imagine, the level of audit review of the estate and gift tax returns filed is down substantially from what it was in earlier years. The IRS National Office is quick to point out that the percentage of returns examined, based upon the number of returns filed, is approximately the same now as it was decades earlier. The additional revenue generated by the handful of agents just here in Michigan and nationwide is staggering compared with the cost to administer the program but the stated policy of this Administration is not to increase the audit level of these returns.

For many years, the Cincinnati Service Center was the beacon of estate tax administration efficiency and the IRS National Office awarded them the opportunity to become the recipient office for all of the estate and gift tax filings for the entire country. Coupled with the demand for new and trained personnel and the simple volume created by this change of the filing requirement, the effectiveness and the timeliness of this once stellar office has been diminished to average. While we certainly cannot fault the estate tax personnel in Cincinnati for these shortcomings, it certainly seems to me that the Service would have been better served had they simply adopted the procedures of the Central Region and applied them to the six or seven other Service Centers that were at one time accepting estate and gift tax returns. This, of course, is so much water under the bridge at this time but every attempt has been made by the people there to try to address the concerns of the tax professionals, not only here in Michigan but across the country. Believe me, from my years inside the Service, this is nearly an impossible task.

A number of my associates from my days at the IRS suggested that the no tax year be extended from just estate taxes to personal and corporate income tax returns as well. While I think the financial markets might like the idea, fiscal policy suggest that a monster may lay in wait behind Door Number 2.

Where does this leave us today? We are now only a little over two years from the complete, but yet temporary, repeal of the Federal estate tax. If you believe that the taxpaying public and their professional advisors will not try to take advantage of this picture window of opportunity, you are foolish. My experience tells me that there will be attempts, some ethical and others not so ethical, to take advantage of this gaping hole in our tax structure. The only real hope we have is that the wisdom of our Congressional bodies will see this problem for what it is and pass legislation so that the tax professionals will be able to sleep at night and that estates will be administered fair and equitably across the board.

Most tax pundits, whoever they are, believe that the new Congress, new in 2009, will quickly address this problem by extending the provisions in effect in that year out to the foreseeable future; thereby ripping this tax opportunity of a lifetime from the cold dead hands of our clients. If that is not the case, and the Congress and White House are somehow deadlocked, we could have absolute chaos, in the transfer tax world, for that year. How we, as tax professionals and estate planners, can effectively draft for these provisions is somewhat bewildering. That is assuming that the changes are not made. But, how long do we wait for Congress to make these changes. Can we effectively wait until the spring of 2009, to the summer, or even into the fall? If we get to that point, we will all be having sleepless nights in searching out new methods to relieve our stress.

One important thing I forgot to mention in all of this is that effective with the repeal of the estate tax in the year 2010, Congress restored that most renowned tax provision of carryover basis. Those of you who have a few grey hairs will remember the 1977 through 1979 period when carryover basis was the law. Trust me, it was great fun then and it will be great fun again, if we have to live with it.

With tongue firmly planted in one's cheek, I have tried to point out the catastrophe that looms beyond the horizon. Hopefully, Congress and the White House will address and rectify this situation early in the 2009. Whether it is a continuation of the 2009 provisions into the foreseeable future or whether it is the granting of further relief to decedents' estates, we have to have some certainty and be able to advise our clients accordingly. Asking Congress to do something that is indeed in everyone's best interest may seem to the skeptics among us as a futile and desperate act but unfortunately, I think it is our best chance to eliminate what I would see as a very dark day for tax administration and efficient estate administration.

Michael J. Mulcahy concentrates on estate planning, estate and trust administration and estate taxation at Varnum, Riddering,Schmidt and Howlett. He is frequently called upon as a valuation expert critiquing appraisals of closely held businesses and real estate. Prior to private practice, he served as an Appeals Officer at the Internal Revenue Service.

The Service Visits the Sins of the Grandfathers Upon the Grandchildren: The Application of the Generation-Skipping Transfer Tax to Grandfathered Irrevocable Trusts that Include General Powers of Appointment

Eric G. Lanning

Introduction

On October 24, 2006, the United States Tax Court issued its opinion in *Estate of Eleanor R. Gerson, et al. v. Commissioner*,[1] and re-opened the debate over the tax treatment of a general power of appointment in a trust that otherwise satisfies the generation-skipping transfer tax ("GSTT") grandfathering rules. The Tax Court ruled against the taxpayer, and has now set the stage for the first Court of Appeals review of this question under the current version of Treasury Regulation section 26.2601-1(b)(1)(i).

I. The Generation-Skipping Transfer Tax

A. Operation of the Tax

The GSTT is one of three regimes that tax transfers of wealth during life and at death.[2] The current GSTT, found in Chapter 13 of the Internal Revenue Code (the "Code"), is, upon a first look, deceptively simple. The GSTT imposes a tax at the highest applicable estate tax rate to any of three types of transfers when the recipient of the particular transfer is a skip person[3] with respect to the transferor.[4] The three generation-skipping transfers are described in Code section 2612.
A "taxable termination" occurs when a beneficiary's interest in a trust terminates and (i) immediately following the termination there is no non-skip person[5] who has an interest in the trust, and (ii) a skip person could receive a distribution from the trust at a time after such termination.[6] A "taxable distribution" occurs when a trustee distributes trust property to a skip person.[7] A "direct skip" transfer occurs when a transfer that is subject to estate or gift taxes (essentially, a gift or transfer at death) is made directly to a skip person.[8]

B. Grandfather Rule

The original intent of the GSTT was to provide the Service with a method for taxing assets that were, through creative estate planning techniques, placed outside of the ordinary chain of succession and application of the estate tax.[9] Specifically, the GSTT would allow the Service to tax assets that were placed in irrevocable trusts that did not distribute the assets out to the beneficiaries for a number of generations, often limited only by the length of the rule against perpetuities period applicable to the trust. Despite this desire to bring such assets back within the reach of the transfer tax system, the drafters of the GSTT also understood that inequity could arise if the provisions of the tax were applied in all instances to irrevocable trusts that were created before the law itself was enacted. In order to address this concern, Congress included section 1433(b)(2)(A) of Tax Reform Act of 1986 (the "TRA") to provide relief to irrevocable trusts that were irrevocable as of September 25, 1986[10] (the "grandfather rule").

The Treasury Department promulgated final GSTT regulations on December 27, 1995. Using language nearly identical to that found in the grandfather rule of the TRA, the regulations provided that in order for a trust to remain safe under the grandfather rule, the trust must not have had any additions made to it following September 25, 1986.[11]

II. Priro Court Decisions

A. E. Norman Peterson Marital Trust v. Commissioner

The Court of Appeals for the Second Circuit was the first Circuit Court to address the effect of Treasury Regulation section 26.2601-1(b)(1)(i) on an irrevocable trust that included a general power of appointment[12] held by a trust beneficiary. In *E. Norman Peterson Marital Trust v. Commissioner*,[13] the trust in question was a marital trust created upon the death of Mr. Peterson in 1974 for his wife, Mrs. Peterson. The terms of the marital trust granted a testamentary general power of appointment to Mrs. Peterson, and provided that if Mrs. Peterson did not exercise this power, the assets of the trust would instead pass to Mr. Peterson's grandchildren from his prior marriage. Mrs. Peterson did not exercise her general power of appointment and as a result, the power lapsed on her death in 1987.

The Service argued that the protection of the grandfather rule should not apply to the marital trust because Mrs. Peterson's general power of appointment over the trust lapsed at her death in favor of skip persons. The Service's argument was based, in large part, on the application of a temporary regulation in effect at the time.[14] Example 1 under the Regulation provided, in essence, that the lapse of a general power over assets in an otherwise grandfathered irrevocable trust would cause such assets to be subject to the GSTT.[15]

The taxpayer's first argument attacked the validity of the temporary regulation as contrary to the plain meaning of the original statute, which provided simply that the grandfather rule is violated on when assets are "added to" the trust.[16] The Court disagreed with the taxpayer, citing the fact that well settled principles of estate and gift tax law treat property subject to a general power of appointment as owned by the powerholder.[17] Thus, any exercise, release or lapse of such power is properly treated as a transfer for estate and gift tax purposes.[18]

The taxpayer's second argument attempted to appeal to the protectionism aspect of the grandfather rule. Mr. Peterson had no way to prepare, at the time of his death, for the imposition of the GSTT.[19] The marital trust came into existence in 1974, over a decade before the enactment of the current GSTT regime. In short, the taxpayer argued, the marital trust represented exactly the situation that the grandfather rule was intended to relieve. The Court disagreed, however, stating that Mr. Peterson had in fact given Mrs. Peterson the ability to avoid the imposition of the GSTT by granting her the general power of appointment.

Despite the taxpayer's arguments, the Court found that the lapse of Mrs. Peterson's general power of appointment resulted in an "addition to" the marital trust, and as a result the protection provided by the grandfather rule did not apply.

B. Simpson v. United States

Several years later, the Eighth Circuit considered a similar factual situation n *Simpson v. United States*.[20] The Court, in finding for the taxpayer, relied on two primary bases for its opinion. First, the Court found that section 1433(b)(2)(A) of the TRA was unambiguous in its requirement that a trust be irrevocable on September 25, 1986, in order to qualify for protection under the grandfather rule. The Court stated that the Service's argument, that the language of the TRA required that the "transfer under the trust" be irrevocable on that date, was misplaced. Instead, the Court found, the phrase "which was irrevocable on September 25, 1986" modified the term "trust," and not the term "transfer." The Simpson trust was, in fact, irrevocable on September 25, 1986, though the general power of appointment was not exercised until 1993. Thus, the Court found that the Simpson trust clearly met the requirement of the TRA.

The second basis for the Court's holding in *Simpson* focused on the case's primary factual distinction from Peterson Marital Trust – the powerholder in *Simpson* exercised the general power of appointment instead of allowing it to lapse. The Court distinguished the facts of *Simpson* from those of *Peterson Marital Trust*, finding that while a lapse of a power is treated as an addition to the trust by the powerholder, an exercise of the power is not treated as an addition to the trust. In fact, by exercising the power, the powerholder is specifically removing property from the trust. The Court stated that the taxpayer in *Peterson Marital Trust* was correctly denied protection under the grandfather rule, but that the factual distinction found in the instant case required a different result.

C. The Service's Nonacquiescence in Simpson

The Service disagreed with the Court's analysis in the *Simpson* case, and issued Action on Decision recommending nonacquiescence in the result in *Simpson*.[21] The Service stressed the argument, as advanced in *Simpson*, that the operative moment for determining the application of the grandfather rule is the exercise (or non-exercise) of the general power of appointment, and not the creation of the trust itself.

D. The Effective Date Regulations

On December 20, 2000, and directly following to the Eighth Circuit's decision in *Simpson*, the Treasury Department promulgated new GSTT regulations (called the "Effective Date" regulations). The Effective Date regulations were issued under the Secretary's general rulemaking authority under Code section 7805(a). The new regulations expanded the Service's interpretation of section 1433(b)(2)(A) of the TRA and the restrictions of the grandfather rule. The new regulations provided that any exercise, lapse or release of a general power of appointment would violate the rule of section 1433(b)(2)(A) of the TRA, and any such exercise, lapse or release would be considered a transfer to which the GSTT would apply regardless of the date on which the trust itself became irrevocable.

With the exception of a single Ninth Circuit case,[22] the central question of the *Peterson Marital Trust* and *Simpson* cases remained essentially untouched for many years, until the Tax Court had a chance to review the identical issue in *Estate of Gerson*.

III. Estate of Gerson

The decedent in *Estate of Gerson*, Eleanor Gerson, died in 2000. Mrs. Gerson held a general power of appointment over a trust created for her by her late husband, Benjamin Gerson. Mr. Gerson died in 1973, at which time the trust he created for Mrs. Gerson became irrevocable. Upon her death, Mrs. Gerson exercised the general power of appointment to fund a grandchildren's trust created under a separate provision of Mr. Gerson's trust. Mrs. Gerson's estate (the "Estate") filed an estate tax return that did not treat the exercise of the power as a generation-skipping transfer. Aware of the battle that laid ahead, the Estate filed an affirmative disclosure together with the estate tax return, stating that the Estate was taking a filing position that was contrary to Treasury Regulation section 26.2601-1(b)(1)(i). As expected, the Service asserted a deficiency against the Estate based on the application of Treasury Regulation section 26.2601-1(b)(1)(i).

The taxpayer's primary argument in *Estate of Gerson* focused, not surprisingly, on the validity of Treasury Regulation section 26.2601-1(b)(1)(i) as an interpretation of section 1433(b)(2)(A) of the TRA. The taxpayer's argument focused on two principles of regulatory deference.

First, the taxpayer argued that the Supreme Court's opinion in *National Cable & Telecommunications Ass'n v. Brand X Internet Services*[23] precluded the viability of Treasury Regulation section 26.2601-1(b)(1)(i). In National Cable, the Supreme Court established the standard for regulatory deference in the specific situation where an Agency promulgates a regulation that is in direct conflict with a prior court decision. The Court stated that "[b]efore a judicial construction of a statute, whether contained in a precedent or not, may trump an agency's, the court must hold that the statute unambiguously requires the court's construction."[24] As the Tax Court noted, Treasury Regulation section 26.2601-1(b)(1)(i) was promulgated immediately following, and presumably in response to, the Eighth Circuit's decision in *Simpson*.[25] The Tax Court's application of the *National Cable* standard in this case was not extensive, however, and the Tax Court summarily dismissed this argument. The Tax Court correctly stated that the *Simpson* Court based its decision on "the plain meaning" of section 1433(b)(2)(A) of the TRA, while the

Tax Court itself and the Second Circuit in *Peterson Marital Trust* found that the "statute must be read in proper context." From this conflict, the Tax Court determined that the "conflicting judicial constructions" did not satisfy the National Cable requirement that the court's prior decision at issue was unambiguously required by the plain language of the statute.

Second, the taxpayer argued that the regulation itself was an invalid attempt by the Treasury Department to "re-write" the applicable statute.[26] The taxpayer relied on the decisions in *Simpson* and *Bachler* to support the argument that the operative question based on the plain language of section 1433(b)(2)(A) of the TRA was whether the trust itself was irrevocable on September 25, 1986. The taxpayer argued that the trust should qualify for grandfather status if it was irrevocable on that date, regardless of whether all of the potential transfers from the trust were also irrevocable on that date. As a result, based on the taxpayer's position, the regulation would not meet the so-called *Chevron* test[27] and would not be valid interpretation of the underlying statute.

The Tax Court, after exhaustively articulating the differences between the various tests of regulatory deference, found that Congress had not spoken directly to the underlying issue, that is, the definition of the phrase "transfer in trust" as found in section 1433(b)(2)(A) of the TRA. As a result, the Tax Court found Treasury Regulation section 26.2601-1(b)(1)(i) to be a reasonable and valid interpretation of section 1433(b)(2)(A) of the TRA.

The Tax Court majority, as well as one of the three concurring opinions, found support for its decision in the application of GSTT principles to the issue in question. The transferor with respect to a generation-skipping transfer is "the individual with respect to whom property was most recently subject to Federal estate or gift tax."[28] The majority opinion found Treasury Regulation section 26.2601-1(b)(1)(i) an important method to ensure that general powers of appointment are treated uniformly for transfer tax purposes. The concurring opinion found support for the validity of Treasury Regulation section 26.2601-1(b)(1)(i) based on the fact that Mrs. Gerson was treated, for GSTT purposes, as the transferor of the assets appointed subject to the power. Because Mrs. Gerson was treated as the transferor, the opinion reasoned, the transfer was necessarily not a "generation-skipping transfer under a trust."[29]

Estate of Gerson is a notable Tax Court opinion, if not for any other reason, because five of the Judges dissented from the majority opinion in two dissenting opinions.[30] The first dissenting opinion, written by Judge Laro, provides a concise analysis of what has been the central issue throughout the cases addressing this issue. That is, what does the September 25, 1986, date measure? Judge Laro's analysis found the underlying statute in this case to be clear and unambiguous in exempting certain irrevocable trusts from the application of the GSTT. Judge Laro found that the correct question under section 1433(b)(2)(A) of the TRA is whether the irrevocable trust in question was irrevocable on September 25, 1986, as the Courts of Appeals for the Eighth and Ninth Circuit had previously found.

IV. Analysis

The central issue throughout the history of this debate is whether the language of section 1433(b)(2)(A) of the TRA merely requires the "trust" in question to be irrevocable on September 25, 1986, or whether a particular "transfer under the trust" must have been irrevocable on that date to enjoy the protection of the grandfather rule. The Service, as well as the Second Circuit and the Tax Court, read the statutory language to require the latter, while the Eighth Circuit, the Ninth Circuit, and five dissenting Tax Court judges the former. As a practical matter, *Estate of Gerson* will likely be appealed to the Sixth Circuit, and the Court will likely render a decision that will add to the confusion whichever way it is decided. However, the ultimate decision (perhaps a Supreme Court opinion) should be based on the correct reading of the statute. In this author's opinion, the Courts in *Simpson* and *Bachler*, as well as the dissents in *Estate of Gerson*, have determined the correct reading of the statutory text. As a result, Treasury Regulation section 26.2601-1(b)(1)(i) should be invalidated.

A plain reading, informed by what Judge Laro refers to in his opinion as the "rule of the last antecedent," requires the conclusion that the irrevocability requirement in the statute applies to the status of the trust itself.[31]

Guidance on the issue can also be found in the regulatory section that neighbors the section in question.[32] This section provides a relatively exhaustive definition, including five separate examples, of an "irrevocable trust." The focus of this definitional provision is when, and under what circumstances, a trust is irrevocable for the purpose of the grandfather rule. The import of this regulatory definition is clear, that the trust in question must itself have been irrevocable on September 25, 1986, in order to fall under the grandfather rule.

The Tax Court's argument (found in both the majority and one of the concurring opinions) that the result in *Estate of Gerson* leads to a result that is congruent with the effect of Treasury Regulation section 26.2652-1(a)(1) is simply circular reasoning – the very purpose of the grandfather provision is to avoid the application of the GSTT in a situation where it would otherwise apply. It necessarily follows that if the Tax Court found that the grandfather provisions were violated, the result would be the same as it would if the grandfather provisions simply didn't apply in the first place. While this is a logically valid argument, it does not provide reasonable support for reaching the conclusion in the first instance.

V. Conclusion

The taxpayers have not yet appealed Tax Court's decision in *Estate of Gerson* to the Sixth Circuit, but based on the weight of the existing precedent, this author expects that the decision will be appealed. The Sixth Circuit has adopted the position that tax regulations promulgated under the general authority of Code section 7805(a) are nonetheless entitled to full *Chevron* deference,[33] and so it is safe to assume that the fact that Treasury Regulation section 26.2601-1(b)(1)(i) is an interpretive regulation will not give the Sixth Circuit any pause. However, the Court will still have to find that the dictates of *Chevron* are satisfied, and in addition in light of the Supreme Court's opinion in *National Cable*. It is an open question whether the Sixth Circuit will be compelled to find that the statutory provisions upon which Treasury Regulation section 26.2601-1(b)(1)(i) is based are unambiguous in their intent to include any irrevocable trust that, by its terms, was irrevocable on September 25, 1986, within the coverage of the grandfather rule. However, until such an opinion is issued, practitioners in the Sixth Circuit (and, indeed, in all circuits with the exception of the Second, Eighth and Ninth) continue to face uncertainty when dealing with a trust that became irrevocable prior to September 25, 1986, and which grants a general power of appointment to a beneficiary.

As the majority and concurrences in *Estate of Gerson* point out, a taxpayer holding a general power of attorney in a grandfathered irrevocable trust can simply exercise the power in favor of a non-skip person in order to avoid the GSTT. This advice may avoid the imposition of the GSTT, but if the powerholder simply does not wish to benefit any person who is not a skip-person, this advice is of little assistance. This result is inequitable because the original grantor did not, by definition, have an opportunity to utilize his or her own GSTT exemption upon forming and funding the trust. Without the ability to effectively "undo" the original transfer, the powerholder is left with the Tax Court's mandated result.

And this, it seems, is the lack of flexibility that Congress had in mind when it crafted the grandfather rule.

Eric G. Lanning is a Senior Counsel in the Law Division of Lincoln Financial Group, where he specializes in insurance and annuity product taxation. Eric received his LL.M. in Taxation from the Thomas M. Cooley Law School in January, 2008. He is a graduate of the Indiana University School of Law – Bloomington, and the University of Michigan.

Endnotes

1. 127 TC 139 (2006)
2. The Estate Tax, found in Chapter 11 of the Internal Revenue Code, and the Gift Tax, found in Chapter 12 of the Internal Revenue Code, is also taxes on the transfer of wealth.
3. A "skip person" is defined under I.R.C. § 2613(a).
4. Each individual has an exemption from the GSTT under I.R.C. § 2631(a) that can be applied to transfers during lifetime or at death. The exemption amount is currently $2 million.
5. A "non-skip person" is defined under I.R.C. § 2613(b).
6. I.R.C. § 2612(a)(1).
7. I.R.C. § 2612(b).
8. I.R.C. § 2612(c)(1).
9. *See, generally,* Harrington, Plaine & Zaritsky, Chapter 1: *An Introduction to the Generation-Skipping Transfer Tax*, GENERATION-SKIPPING TRANSFER TAX (WG&L).
10. Section 1433(b)(2)(A) provides that the GSTT, as amended by the TRA, does not apply to "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 …"
11. Treasury Regulation § 26.2601-1(b)(1)(i), as originally promulgated, provided that "[t]he provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985."
12. As provided in I.R.C. § 2041(b)(1), a general power of appointment is a power that is exercisable in favor of the powerholder, the powerholder's estate, or the creditors of either.
13. 78 F.3d 795 (2nd Cir. 1996).
14. Temporary Treasury Regulation § 26.2601-1(b)(1)(v)(A).
15. *Id*.
16. Peterson Marital Trust, 78 F.3d at 799.
17. *Id* at 800.
18 *Id*.
19 *Id*. at 801-802.
20. 183 F.3d 812 (8th Cir. 1999), nonacq. 2000-9 I.R.B. 711.
21. A.O.D. 2000-003 (March 7, 2000).
22. In *Bachler v. United States*, the Ninth Circuit considered the issue, and on facts that were nearly identical to those found in Simpson. The trust at issue in Bachler was created under the will Mr. Wunderlich, who died in 1976. Mrs. Wunderlich, the powerholder, exercised the general power of appointment as of her death in 1997. Following the analysis of the Simpson Court, the court in Bachler found that the trust in question was irrevocable on September 25, 1986, and thus the 1997 exercise of the general power of appointment was not subject to the GSTT.
23. 545 U.S. 967 (2005).
24. *Id* at 985.
25. 127 TC at 152.
26. *Id*. at 151.
27. *Chevron U.S.A., Inc. v. Natural Resource Defense Council, Inc.*, 467 U.S. 837 (1984) articulates a "two prong analysis" that is used to determine whether a regulation implements the underlying statute in a reasonable manner, thus entitling the regulation to the force and effect of law.
28. Treasury Regulation § 26.2652-1(a)(1).
29. 127 TC at 164.
30. The second dissenting opinion, written by Judge Vasquez, reviews the various standards of deference given to interpretive regulations. However, the Sixth Circuit (to which *Estate of Gerson* is appealable) has addressed the issue of regulatory deference and applies Chevron deference to all tax regulations.
31. *See* 2A Singer, Sutherland Statutory Construction, §47:33 (6th Ed. 2000).
32. Treasury Regulation § 26.2601-1(b)(1)(ii).
33. *See* Peoples Federal Savings & Loan Association v. Commissioner, T.C. Memo 1990-129, rev'd. 948 F.2d 289, 299-300 (6th Cir. 1991).

AN ACADEMIC AND A FORMER IRS AGENT DISCUSS THE IRS PERSPECTIVE ON FAMILY LIMITED PARTNERSHIPS[1]

Daniel W. Matthews

Lorraine New

INTRODUCTION

The great German philosopher Arthur Schopenhauer once said, "[e]very man takes the limits of his own field of vision for the limits of the world."[2] In the case of estate and gift tax planning, practitioners often limit their field of vision to the goal of tax minimization. When limiting their vision in this manner, practitioners may fail to see that hypothetical justifications for their techniques cannot disguise the fact that such techniques are completely tax motivated. So practitioners are seemingly caught blindsided by the Service's response that their techniques serve no legitimate nontax purpose.

The divergent perspectives of practitioners and the Service to tax planning arise in the case of the family limited partnership (FLP)[3] technique, which practitioners have employed to substantially reduce estate and gift tax liabilities of their clients. From the perspective of the practitioner, the FLP provides the "magic of disappearing value." To explain, the transferor first contributes assets to a FLP in exchange for a limited partnership interest. Next, the transferor gives the limited partnership interest to loved ones, either during life or at death. If the FLP properly maintains its capital accounts, no value has shifted and no taxable gift occurs upon formation of the FLP. The magic of disappearing value occurs upon gift or devise where the amount includible in the tax base is equal to the limited partnership interest's fair market value. Because the limited partnership interest is discounted for lack of control and lack of marketability, the difference between the value of the contributed assets and the value of the limited partnership interest forever escapes estate and gift taxation.

Initially, the FLP was often used in business succession planning from one generation to the next. But some zealous practitioners expanded the use of the FLP technique to clients with no active business interests. Thus, the FLP could, in theory, be used as a way to make the value of cash and marketable securities disappear. These practitioners believed they could then legitimize the FLP with hypothetical business reasons, such as asset protection, centralized management of assets, and tutelage of the younger generation in investing.[4]

The Service understandably views the FLP as a sleight-of-hand illusion. Instead of disappearing value, the Service sees the FLP as a "recycling of value." The contributed assets often remain intact within the FLP. Therefore, the Service views the taxpayer's relationship to the contributed assets to be essentially the same before and after formation of the FLP. In this way, the Service views the FLP, especially those consisting mostly of cash and marketable securities, as indistinguishable from a revocable trust.[5]

Practitioners need to step back, heed Schopenhauer's advice, and not limit their perspective to that of zealous tax minimization. Practitioners must understand and appreciate the Service's perspective in order to avoid unnecessary confrontation with the Service. This article is an attempt to provide the Service's perspective to practitioners. In the first part of this article, Professor Dan Matthews discusses the recent and pertinent case law involving family limited partnerships. In the second part of this article, former IRS agent Lorraine New discusses the Service's perspective on FLPs and addresses audit triggers and procedures. Finally, Professor Matthews and Ms. New conclude this article by answering open questions about FLPs and providing sensible advice to practitioners.

II. FLP LITIGATION AND CASE LAW

A. SECTION 2036, BONA FIDE SALE EXCEPTION, AND BUSINESS PURPOSE

Because the magic of disappearing value is so enticing, the FLP caught fire, was oversold to clients, and the Service began to fight back. Initially, the Service challenged the size of the discounts for lack of control and lack of marketability.[6] Then the Service attacked the FLP itself. Through trial and error, the Service began its attack on the FLP. Initially, in *Estate of Strangi v. Commissioner ("Strangi I")*[7] , the Service unsuccessfully argued that (1) an FLP was a sham lacking economic substance, (2) the transferred value was recaptured under Code section 2703, and (3) the transferor made a taxable gift upon formation. After losing in the Tax Court in Strangi I, the Service changed its approach, arguing instead that the value was recaptured by the provisions of Code section 2036(a).

The current version of section 2036(a) states:

> (a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Treasury Regulations further explain that "[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred."[8]

In the first round of cases decided under section 2036, the courts focused on section 2036(a)(1) and (a)(2). With respect to section 2036(a)(1), the courts often found an implied agreement between the transferor and the FLP's general partner that the transferor would retain a "right to income" or "possession or enjoyment" of the transferred property.[9] Similarly, the Tax Court has found that if the transferor retained de facto control over the general partner, the transferor can effectively designate who can receive distributions from the FLP and thereby implicate section 2036(a)(2).[10]

Recent cases have correctly focused on what constitutes "a bona fide sale for adequate and full consideration in money or money's worth," otherwise known as the "bona fide sale exception." If the bona fide sale exception applies, there is no need to discuss whether section 2036(a)(1) and (a)(2) apply. If the FLP fails to meet the bona fide sale requirement, the court will most certainly find an implied agreement to retain enough "strings" to implicate either section 2036(a)(1) or (a)(2).[11] Therefore, the estate must satisfy the bona fide sale exception to achieve the desired discounts.

As shown in the cases that follow, an FLP must have a legitimate and significant nontax purpose for its existence to satisfy the bona fide sale exception. This begs the following questions to be addressed: Can an FLP funded primarily with cash and marketable securities have a legitimate and significant nontax purpose? If not, what percentage of cash and marketable securities can an FLP hold and still have a legitimate and significant nontax purpose? Is there any legitimate and significant nontax purpose for an elderly client in very poor health to form an FLP, especially if the FLP is formed by an attorney-in-fact acting on behalf of such elderly client? Do standard justifications for formation of an FLP, such as asset protection, centralized management of assets, and tutelage of the younger generation in investing, create a legitimate and significant nontax purpose?

Before delving into the Service's position on these issues, a discussion on recent FLP case law is in order. In the first set of cases discussed herein, the Service was successful in including the entire value of the assets transferred to the FLP in the decedent's gross estate. In the second set of cases, the estate successfully defended on the bona fide exception, so that the estate was able to claim discounts on the assets transferred to the FLP.

B. BAD FACTORS WILL RESULT IN INCLUSION UNDER SECTION 2036

In the cases where the estate has been unsuccessful in achieving the desired discounts, the estate has been unable to show a legitimate and significant nontax reason for the FLP's formation.[12] In each case, the estate had a number of bad factors working against it, none of which by itself may be determinative on the issue of a legitimate and significant nontax purpose. But the estate had no chance to show a legitimate and significant nontax purpose where these bad factors were viewed in the aggregate. These bad factors include advanced age and ill health of the transferor, insufficient funds to cover living expenses after the transfer, transfers by transferor's children acting as attorney-in-fact, FLPs funded primarily with cash and marketable securities, and FLPs holding personal use assets, such as the transferor's principal residence.

The seminal cases involving bad factors are *Estate of Thompson v. Commissioner*,[13] *Estate of Strangi v. Commissioner*,[14] and *Estate of Abraham v. Commissioner*,[15] decided by the Third, Fifth, and First Circuits, respectively. In addition to the Circuit Court decisions, the Tax Court has issued several memoranda decisions on cases involving bad factors, including *Estate of Rosen v. Commissioner*,[16] *Estate of Erickson v. Commissioner*,[17] *Estate of Korby v. Commissioner*,[18] and *Estate of Disbrow v. Commissioner*.[19] Each of the above mentioned cases are discussed herein.

1. ESTATE OF THOMPSON V. COMMISSIONER

In *Estate of Thompson v. Commissioner*,[20] the decedent, at age 95, transferred $2.8 million in assets, $2.5 million of which were marketable securities, to two FLPs, one of which for the benefit of his daughter (the "Turner Partnership") and the other for the benefit of his son (the "Thompson Partnership"). After making the transfers, decedent retained about $153,000 in personal assets, and received an annual income of $14,000 from social security and two annuities.

In attempt to pool assets and legitimize the FLPs, decedent's daughter contributed real estate worth $49,000 to the Turner Partnership. However, the Turner Partnership agreement allocated all gains and losses from contributed real estate to the individual contributing partners. Furthermore, the Turner Partnership invested $186,000 in a failed modular home development, which lost $60,000, although decedent's daughter brokered the sale and earned a $9,120 commission on the deal. The Turner Partnership made loans to family members, which were often paid late or not paid at all.

Similarly, in order to pool assets in the Thompson Partnership, decedent's son contributed $372,000 in mutual funds and a Colorado ranch valued at $460,000 to the Thompson Partnership. Decedent's son used the ranch as his personal residence and paid a nominal annual rent of $12,000. Decedent's son received a management fee from the corporate partner in excess of the annual rent, thereby causing the Thompson Partnership to operate at a loss.

When decedent died, the estate claimed a 40% lack of control and lack of marketability discount on his limited partnership interests. The Third Circuit held that section 2036(a)(1) applied, as decedent and his children had an implied agreement that he would retain the economic enjoyment from the assets he transferred.[21] Because decedent transferred 95% of his assets at age 95, leaving himself with insufficient funds for his living expenses based on his life expectancy, the Third Circuit inferred that his children would agree to his requests for money should he have needed it.[22] Indeed, decedent's son and daughter met with financial advisers asking how decedent would be able to draw assets from the FLPs.[23]

The Third Circuit next decided that the formation of the FLPs did not satisfy the bona fide sale exception. The Third Circuit did not specifically define what constitutes a bona fide sale and what constitutes adequate and full consideration. Nevertheless, *Estate of Thompson* is significant, as the Third Circuit stressed the importance of the FLP operating a "legitimate business" to meet the exception.[24] While the Third Circuit recognized that rental real estate can constitute legitimate, "active operations,"[25] it rejected the Thompson Partnership's rental of the Colorado ranch as legitimate for two reasons. First, the decedent's management fee was greater than the rent he paid on the same property. Second, the income and expenses of the Colorado property, pursuant to the partnership agreement, were specially allocated back to decedent's son.

With respect to the Turner Partnership, the modular home development gave the Third Circuit "some pause" in determining whether there was a legitimate business.[26] However, because the amount invested in the modular home development ($186,000) was de minimis in comparison to the amount invested in marketable securities (over $1.2 million), the Third Circuit held the modular home development was insufficient to legitimize the Turner Partnership.[27] Because the bona fide sale exception did not apply, section 2036(a)(1) was applicable, and the undiscounted value of the assets decedent transferred to the FLPs was includible in his gross estate.

2. Estate of Strangi v. Commissioner

In Estate of *Strangi v. Commissioner,* [28] decedent's son-in-law, acting on decedent's behalf as power attorney, created a FLP two months prior to decedent's death. In doing so, decedent's son-in-law transferred nearly 98% of the decedent's assets – including personal-use assets such as his principal residence – valued at approximately $10 million to the FLP. In exchange, the decedent received a 99% limited partnership interest and 47% of the outstanding stock of the corporate general partner. At the time of the transfer, the decedent was in poor health and only expected to live for another twelve to twenty-four months. Decedent only retained $786 in liquid assets, although his monthly expenses averaged nearly $17,000 over the two months between formation of the FLP and his death. Both prior to and after decedent's death, the FLP made various outlays, both monetary and in-kind, to meet decedent's needs and personal expenses. On its estate tax return, the estate discounted the decedent's limited partnership interest by 40% for lack of control and lack of marketability. [29]

The Fifth Circuit first considered the bona fide sale exception, which consists of two discrete prongs: (1) bona fide sale, and (2) adequate and full consideration.[30] The court held that a bona fide sale must serve "a 'substantial business [or] other non tax' purpose."[31] In response, the estate offered five non-tax reasons for the formation of the FLP. The estate claimed that formation of the FLP would accomplish the following: (1) deter a lawsuit from decedent's former housekeeper who had been injured in the decedent's residence; (2) defer a will contest initiated by decedent's step-children; (3) dissuade a corporate trustee from serving as an executor; (4) create a joint investment vehicle for the partners; and (5) permit centralized, active management of decedent's "working assets."

The Fifth Circuit found that deterring the housekeeper's lawsuit and the step-children's lawsuit were either not likely to happen or would not likely be successful. Accordingly, the Fifth Circuit rejected the "deterrence of lawsuits" rationale as a non-tax reason for the FLP's formation.[32] Similarly, the court found no casual relationship between the corporate fiduciary's refusal to serve as executor and formation of the FLP. [33]

The Fifth Circuit was not convinced that the FLP acted as a legitimate joint investment vehicle. The decedent's children invested $55,650 in the FLP, in comparison to the decedent's nearly $10 million. The Fifth Circuit did not adopt a per se rule that minimal or *de minimis* contributions from other family members forecloses the possibility that joint investment vehicle reason is legitimate. However, in cases where the FLP fails to make its own actual investments, instead of merely holding assets contributed to it, the Fifth Circuit held that a fact finder can infer that a de minimis contribution of the other family members makes the joint investment objectively unlikely.[34] Finally, the Fifth Circuit rejected the active, centralized management justification. The overwhelming majority of the assets the decedent contributed to the FLP did not require active management, i.e., marketable securities held in brokerage accounts.[35] Because the bona fide sale exception was not applicable, the Fifth Circuit upheld that Tax Court's ruling that the value of the transferred assets were includible in decedent's gross estate under section 2036(a).

3. Estate of Abraham v. Commissioner

In Estate of *Abraham v. Commissioner*,[36] the decedent suffered from Alzheimer's disease and was placed under guardianship in 1993. Shortly thereafter, litigation ensued between the decedent's children over the amount needed for the decedent's support. In 1995, to ensure that decedent's financial needs would be met and to prevent waste of her assets, the probate court entered a stipulated decree requiring the establishment of an estate plan for the decedent.

As part of the estate plan, three of decedent's income-producing commercial properties were transferred to three FLPs. The decedent and her children were partners in those FLPs. Between the time the FLPs were formed and decedent's death in 1997, the decedent, through her guardian, transferred percentage interests of her share in the FLPs to her children and their families. In addition, the decedent's daughters each "purchased" limited partnership interests. One daughter wrote a check directly to the decedent for her limited partnership interest. The check, however, was deposited in the FLP account. In a later purchase, a daughter wrote a check directly to the FLP to purchase limited partnership interests that the decedent owned.

The estate applied minority and lack of marketability discounts to the percentage interests in the FLPs that the decedent still held at her death. The Service contended that the entire value of the properties transferred to the FLPs were includible in decedent's gross estate under Section 2036, as decedent retained the enjoyment and use of the properties until her death. The Tax Court agreed with the Service. Upon appeal to the First Circuit, the estate argued that (1) the daughters' purchases of percentage interests in the FLPs were bona fide sales for adequate consideration, and (2) the decedent did not retain a right to the income from the commercial properties transferred to the FLPs.

The estate argued that, except for the gifted limited partnership interests, the daughters purchased their limited partnership interests for full and adequate consideration. The First Circuit held that the estate failed to show that the daughters paid adequate consideration for their FLP interests. It also noted that the Service applied Section 2043 to reduce the amount includible in the estate for the FLPs by the consideration the daughters paid.

The First Circuit held that the decedent retained the right to income from the assets transferred to the FLPs. According to the court, all parties understood that the guardian had the discretion and the approval of the family to use all FLP income, if necessary, for decedent's support. The court further noted that the fact that it was unnecessary to use more than the decedent's percentage share of the income was not dispositive. The court stressed that Section 2036 does not require the decedent to have retained a legally enforceable interest. Rather, the court emphasized that inclusion can be triggered under Section 2036 if enjoyment of the transferred property is retained under an implied understanding. Based on these facts the court included the full value of the commercial properties transferred to the FLPs in the decedent's gross estate under Section 2036.

4. Estate of Rosen v. Commissioner and Estate of Erickson v. Commissioner

In *Estate of Rosen v. Commissioner*,[37] at a time when the decedent was suffering from dementia and Alzheimer's disease, decedent's daughter acting as decedent's attorney-in-fact transferred cash and marketable securities held in decedent's living trust to a FLP in return for a 99% limited partnership interest. Following this transfer, the transferred assets were simply moved from one Merrill Lynch account to another and managed in the same manner. The FLP conducted no business activity and had no business purpose for its existence. The attorney who helped create the FLP did not speak to the decedent about the FLP, nor did he know whether the decedent was competent.

The Tax Court held that the entire amount of the decedent's assets transferred to the FLP were includible in her gross estate. To satisfy the bona fide sale exception, the Tax Court held that the estate must show that the FLP was formed for a "legitimate and significant nontax reason."[38] The Tax Court offered several factors showing that the only purpose for forming the FLP was to avoid estate tax. First, the FLP did not engage in a functioning business operation. Second, the FLP was not formed as part of a bona fide negotiation, as the decedent's attorney-in-fact formed the FLP and stood on all sides of the transaction. Third, because funds family members used for their interests in the FLP were acquired by gift from the decedent, the decedent effectively funded the FLP entirely by herself. Fourth, because cash and marketable securities continued to be held in a Merrill Lynch account before and after the transfer, no meaningful change occurred in the decedent's relationship to her assets after transfer. Fifth, the decedent was unable to satisfy her financial obligations without the use of FLP funds. Sixth, the assets transferred were solely cash and marketable securities. And finally, the decedent was of an advanced age and very ill at the time of the transfer.

The Tax Court reached the same conclusion in *Estate of Erickson v. Commissioner*,[39] on facts substantially similar to *Rosen*. In *Erickson*, at a time when the decedent was 88 years old and suffering from Alzheimer's disease, decedent's daughter acting as decedent's attorney-in-fact transferred $2 million in cash and marketable securities to an FLP. After the transfer, the decedent retained insufficient liquid assets to cover her living expenses.

The Tax Court reiterated that the FLP must be formed for a legitimate and significant nontax reason to satisfy the bona fide sale exception. The Tax Court noted that the FLP was merely a collection of passive assets, such as marketable securities and rental properties that remained unchanged after contribution. Moreover, decedent's daughter, as attorney-in-fact, was on all sides of the transaction, so that the FLP was not formed as part of a bona fide negotiation. The decedent was in such a condition that she could not understand the transaction. Lastly, after the transfer, decedent could not satisfy her debts. Indeed, the estate had to borrow nearly $200,000 from the FLP to pay its debts.

5. Estate of Korby v. Commissioner

In *Estate of Korby v. Commissioner*,[40] a married couple established an FLP, which they capitalized with approximately $1.88 million in marketable securities. In return, the couple's joint living trust received a 2% general partnership interest. The same joint living trust also received a 98% limited partnership interest. The husband and one of his sons acted as co-trustees of the joint trust. Because the wife was diagnosed with Alzheimer's disease, she did not serve as a trustee of the joint trust. Shortly after the FLP's formation, the couple gifted the 98% limited partnership interest in equal shares to irrevocable trusts established for their four sons. The couple reported 43.61% minority and marketability discounts on these transfers on their gift tax returns.

After the transfer of the marketable securities to the FLP and the subsequent gifting, the married couple was left owning a house, a vacant lot, personal items, bank accounts with a total balance of $7,428, and the 2% general partnership interest. As a result, the married couple was dependent primarily on social security for their income. The couple both needed medical care and reported medical expenses of over $ 37,000 – approximately double their social security income. The FLP paid the husband a "management fee," which he used to pay for these excess medical expenses.

The Tax Court determined that the undiscounted value of the assets the husband transferred to the FLP were includible his gross estate under Section 2036. Likewise, the Tax Court held that the undiscounted value of the assets the wife transferred to the FLP were includible in her gross estate under Section 2036. Because the couple's social security income and remaining assets were insufficient to cover their anticipated expenses, the court found an implied agreement between the couple and their children that the FLP's assets would be available to the couple as long as they needed income. The estates unsuccessfully argued that the cash payments that FLP made to the couple were management fees paid for the husband's services as a money manager for the FLP assets. The court noted that no management contract was executed, the fees were not based on any regular or prescribed method of payment or computation, and the degree of anticipated management the marketable securities transferred to the FLP was minimal.

The couple's transfer of assets to the FLP did not qualify for the bona fide sale exception under Section 2036. The Tax Court noted that the FLP was not formed as part of a bona fide negotiation. The husband stood on both sides of the transaction and he alone dictated the terms of the deal, including the management fees. Moreover, the couple's retained use of FLP income was inconsistent with a bona fide transaction. Finally, the Tax Court's rejected the estates' argument that the FLP served a legitimate non-tax reason by protecting family assets from creditors. The Tax Court held that the estates could not show that the terms of the FLP agreement would prevent a creditor of a partner from obtaining the FLP interest in an involuntary transfer. Thus, creditor protection was not a legitimate non-tax reason for forming the FLP.

6. Estate of Disbrow v. Commissioner

In *Estate of Disbrow v. Commissioner*,[41] the decedent gifted her personal residence to a newly formed general partnership whose general partners were the decedent, her children, and spouses of her children. Shortly thereafter, the decedent gave all of her partnership interests to the other partners. Nevertheless, the decedent continued to reside at the residence until her death (except for times when she was hospitalized). While the decedent paid rent to the partnership for use of the residence, such rent was below the fair rental value of the residence.

The Tax Court held that the value of the residence was includible in the decedent's gross estate under Section 2036(a)(1), as she retained the possession and enjoyment of the residence until her death. The Tax Court pointed to several facts detrimental to the estate. The partnership did not conduct business, nor was it ever operated to produce a profit. The assets of the partnership consisted of the residence and a checking account that the decedent contributed. The partnership did not treat decedent as a bona fide tenant, as the decedent was able to pay rent below fair rental value and often paid rent late. Furthermore, the court found an implied understanding between the partners that the partnership would not evict the decedent from the property. Finally, the decedent was in very poor health upon the partnership's formation (she had suffered from severe care of peritonitis, kidney failure, a fractured pelvis, a fractured hip, two broken legs, and had suffered multiple heart attacks in the few years prior to her death).

C. Certain Good Factors Will Satisfy Bona Fide Sale Exception

In cases where the estate has been successful in achieving the desired discounts, the estate was able to establish a legitimate and significant nontax reason for the FLP's formation. Certain "good factors" that may establish a legitimate and significant nontax purpose include the transfer of assets requiring active management, implementation of an established "buy and hold" investment strategy, significant contributions from family members to legitimately pool assets, and transfers to facilitate an initial public offering. The cases illustrating these good factors include *Kimbell v. United States*, *Estate of Bongard v. Commissioner*, and *Estate of Schutt v. Commissioner*, which are discussed herein.

1. Kimbell v. United States

In *Kimbell v. United States*,[42] the decedent, at age 96 and less than three months prior to her death, transferred $20,000 (via her living trust) for a 50% membership interest in an LLC. The decedent's son and his wife each transferred $10,000 for a 25% membership interest in the LLC. Shortly thereafter, decedent's living trust and the LLC formed an FLP. The LLC contributed $25,000 for a 1% general partnership interest in the FLP. The decedent's living trust contributed approximately $2.5 million in cash, oil and gas interests, securities, notes and other assets for a 99% pro-rata limited partnership interest. Therefore, decedent, through her living trust and the LLC, owned 99.5% of the FLP.

At the inception of the FLP, the oil and gas interests constituted approximately 15% of the FLP's assets. The decedent retained over $450,000 in personal assets outside the LLC and FLP for her living expenses. After the decedent's death, the estate claimed a 49% discount on her 99% limited partnership and her membership interest in the LLC for lack of control and lack of marketability. Upon audit, the Service completely denied the discounts by finding that the value of the assets transferred to the LLC and FLP, as opposed to the interests themselves, were includible in the decedent's gross estate under section 2036(a). The district court agreed with the Service, holding that section 2036(a) recaptured the undiscounted value of the assets transferred to the LLC and FLP.[43]

On appeal, the Fifth Circuit first addressed whether the decedent's transfer to the FLP was a bona fide sale for adequate and full consideration. The Fifth Circuit implicitly accepted the district court's assertion that the exception consists of two prongs, namely, (1) the sale must be bona fide, and (2) the sale must be for adequate and full consideration.[44]

With respect to the adequate and full consideration prong, the Service argued that the acquired partnership interest must have a value of 100 cents on the dollar to the contributed assets.[45] After all, the Service argued that it is inconsistent for the estate, on the one hand, to argue for a 49% discount on the limited partnership interest, and on the other hand, claim that the decedent received adequate and full consideration for the transfer.[46] The Fifth Circuit held that the Service's argument missed the mark. Specifically, the court reasoned that investors acquire interests with expectations other than immediately receiving 100 cents back on each dollar invested, such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability.[47] Therefore, the court held,

> there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest in an arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid – a classic informed trade off.[48]

In contrast to the Service's subjective 100 cents on the dollar approach, the court adopted three objective requirements for adequate and full consideration, including (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partnership, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions equal to their respective capital accounts.[49] In this case, the FLP satisfied these three requirements. Accordingly, the Fifth Circuit held that the adequate and full consideration prong was satisfied.

With respect to the bona fide sale prong, the Fifth Circuit held that the decedent's transfer of assets to the FLP was bona fide, as an objective manner, because the "transaction was entered into for substantial business and non-tax reasons."[50] First, the decedent retained sufficient assets to support herself and there was no evidence that the FLP paid the decedent's personal expenses. Second, the FLP complied with partnership formalities and her assets were actually transferred to the FLP. Third, the majority of the oil and gas interests transferred to the FLP were working interests, which required active management. Finally, the estate advanced several "credible and unchallenged non-tax reasons" for the formation of the FLP that could not be accomplished via a living trust. For instance, the oil and gas interests carried with them potential environmental liabilities, and the FLP, in comparison to a living trust, afforded the decedent personal liability protection. Additionally, the FLP accomplished the task of pooling the decedent assets under one management, thereby reducing administrative costs by keeping all accounting functions together. Also, placing the oil and gas interests in a FLP avoided the costs of recording transfers as they were passed from generation to generation. Because the bona fide sale exception applied to the decedent's transfer to the FLP, the Fifth Circuit reversed the district court's ruling that the transferred assets were includible under section 2036(a).[51]

2. ESTATE OF BONGARD V. COMMISSIONER

In *Estate of Bongard v. Commissioner*,[52] the decedent founded Empak, Inc. and owned a majority of its outstanding stock. An irrevocable trust that decedent created (the "ISA Trust") owned the remaining portion of the stock Empak's stock. In December 1996, the decedent and the ISA Trust transferred their Empak stock to a newly formed LLC, receiving proportionate Class A and Class B membership units in return. The decedent's advisor recommended the transfers of Empak stock to the LLC as part of a strategic plan to position Empak for a private or public offering of stock. The advisor determined that investors would be more likely to invest in Empak if the decedent's family members' interests were placed in the LLC.

One day after forming the LLC, the decedent and the ISA Trust transferred their Class B membership units in the LLC to a newly formed FLP. In return, the ISA Trust received a proportionate 1% general partnership interest and the decedent received a proportionate 99% limited partnership interest (although he later gave a 7.72% limited partnership interest to his wife pursuant to a post-marital agreement). The reasons given for the FLP's formation were quite standard. These reasons included facilitation of gift giving to his children without deterring them from working hard, asset protection and deterrence of lawsuits, greater flexibility than trusts, and tutelage with respect to managing the family's assets. Nevertheless, from its inception until the decedent's death, the FLP did not perform any activities, never diversified its assets, and never made any distributions. The FLP merely continued to hold the Class B membership units contributed to it.

The decedent died unexpectedly at age 58 on a hunting trip in November 1998. The decedent appeared to be in good health prior to his death. On its estate tax return, the estate reported a combined value of $45,523,338 for his remaining Class A units and his limited partnership interest. The Service determined that the undiscounted value of all Empak shares the decedent transferred to the LLC were includible in his gross estate under section 2036(a). As a result, the Service valued the decedent's Empak shares at $141,621,428, which resulted in an estate tax deficiency of $52,878,785.

After reviewing its prior FLP decisions and similar cases from the Circuit Courts, the Tax Court held that the bona fide sale exception "is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred."[53] The court further stated, "[a] significant purpose must be an actual motivation, not a theoretical justification."[54] In the context of intrafamily transactions, the Tax Court noted that intrafamily transactions are not per se illegitimate, but such transactions do require heightened scrutiny.

The Tax Court separately addressed both the transfer of the Empak stock to the LLC and the transfer of the Class B units to the FLP under the bona fide sale exception. With respect to the transfer of the Empak stock to the LLC, the Tax Court held that such transfer met the bona fide sale exception. In Tax Court's opinion, the decedent had a legitimate and significant nontax reason for forming the LLC. The court accepted the estate's explanation that the decedent formed the LLC for the legitimate nontax purpose of facilitating a public offering of Empak's stock. Moreover, the court twice noted that the formation of the LLC occurred while the decedent was "in good health."

The Tax Court also held that the transfer of Empak stock was made for adequate and full consideration. The Service again raised the 100 cents on the dollar argument, and in fact, argued that Mr. Bongard should have received a control premium for his majority interest in the LLC. The court rejected the Service's argument, noting that Mr. Bongard received an interest in the LLC proportionate to the value of the Empak stock he transferred to the LLC. However, the court admitted that proportionality, by itself, may not be sufficient to meet the adequate and full consideration prong. The court held the LLC must also properly maintain its capital accounts, which it did.

In contrast to the legitimate formation of the LLC, the Tax Court found no legitimate and significant nontax reason for the formation of the FLP. The estate unsuccessfully argued that the FLP gave the decedent an extra layer of creditor protection and facilitated the gift of a limited partnership interest to his wife pursuant to the post-marital agreement. The Tax Court found that the estate never adequately explained why it needed to form the FLP to accomplish these tasks with the LLC already in place. The LLC already provided liability protection and the gift to decedent's wife could have been as easily accomplished through the LLC as it was through the FLP. In other words, the LLC could accomplish all the tasks offered as a reason for formation of the FLP.

Because the bona fide sale exception did not apply to the FLP's formation, the court had to address whether the value of the Class B membership units transferred to the FLP were recaptured under section 2036(a)(1) or (a)(2). The estate contended that the general partner's fiduciary duty to the FLP precluded any finding of an implied agreement that the decedent would retain enjoyment of the transferred assets during his lifetime. In response, the Tax Court held that the lack of activity following the FLP's formation reinforced the fact that formation of the FLP did not alter the decedent's relationship to the transferred assets.[56] Therefore, the Tax Court sided with the Service, holding that the value of the transferred assets was recaptured under section 2036(a).

3. Estate of Schutt v. Commissioner

In *Estate of Schutt v. Commissioner*,[57] the decedent was married to an heiress of the DuPont family. One year prior to his death, the decedent transferred via his revocable living trust a substantial block of DuPont and Exxon stock to two Delaware business trusts (one to hold DuPont stock and the other to hold Exxon stock) established for the benefit of his descendants. Two trusts that the decedent's late father-in-law created and a trust his late wife created contributed a majority of the DuPont and Exxon stock to the respective business trusts. As a result, the decedent's revocable trust received minority interests in the business trusts in exchange for its DuPont and Exxon stock. The decedent retained assets outside of the business trusts totaling approximately $30 million.

The decedent had a very strong conviction for a "buy and hold" investment philosophy, in particular for the family's large holding in DuPont and Exxon stock. The decedent was displeased with his family members when they sold a considerable amount of shares of DuPont and Exxon stock. The decedent was concerned that upon termination of his father-in-law's trusts and his late wife's trust, his descendants would receive distributions of the DuPont and Exxon stock, which they then could immediately sell. By establishing the business trusts with his father-in-law's trusts and his late wife's trust, his descendants would receive interests in the business trusts upon distribution, rather than the DuPont or Exxon stock.

The decedent's estate reported the revocable trust's interests in the business trusts at a substantial discount. The Service argued that the undiscounted value of the DuPont and Exxon stock transferred to the business trusts were includible in the decedent's gross estate under Section 2036. The estate and the Service stipulated that the estate was entitled to a 32.5% discount if Section 2036 did not apply.

The Tax Court determined that decedent's transfers of stock to the business trusts satisfied the bona fide sale exception of Section 2036. The Service argued that the decedent's contribution of stock to the business trusts was a mere "recycling of value" designed to obtain substantial discounts. The Tax Court recognized that holding an untraded portfolio of marketable securities is normally a negative factor in finding a legitimate, non-tax reason. This case was distinguished, however, from other "recycling of value" cases where one person almost exclusively contributed the securities. In this case, the decedent's contribution was less than half of the assets contributed to the business trusts (decedent's father-in-law's trusts and his late wife's trust contributed the majority of the assets). Additionally, the business trusts were specifically designed to cause retention of the DuPont and Exxon stock after expected termination of the descendants' trusts. Therefore, the Tax Court found the estate's "buy and hold" strategy sufficient to satisfy the bona fide sale exception.

III. IRS Perspective and Audit Triggers

Every estate and gift tax return receives a hands-on review by an IRS examiner, and is selected for possible audit if a questionable item is found. Unlike the computerized scores that are used to review and select income tax returns for audit, estate tax attorneys actually read wills and trusts, appraisals, and check the entries on the estate tax or gift tax return. One of the items that triggers attention is a large, unsupported discount on a business entity, such as an FLP. Any amount of discount can be suspect, and an examiner relies upon his or her experience and discretion in deciding which returns are sent to the field office for audit. An examiner can determine very little about an entity and its business purpose at the selection level, except perhaps the age of the decedent when the entity was set up. By disclosing adequate information about the business entity, the donor or estate may be able to supply enough information to the reviewer to avoid the transfer of the return to the field office for audit. Practitioners should make sure that an appropriate appraisal accompanies the return, along with a copy of the entity's operating agreement, information about ownership, gifts and assignments, any sales and any buy-sell agreements. Additionally, practitioners may want to discuss the facts of business interests of the estate in a simple overview.

Pertinent to the examiner are the health of the donor at the time of formation or gift, character of the assets, reasons for setting up the entity, summary of business operations, and management rights and activities, especially if "good facts" prevail in the analysis of why the entity should be respected. If the information is convincing, the estate may receive a closing letter. If not, the examiner will seek to develop "bad facts" by asking a number of questions during the audit process.

An examiner will want to review the decedent's background, lifestyle, gift history and assets to help determine if there are missing assets or gifts. He or she is looking for a clearer picture of the donor or decedent's financial situation and the funding of the gift or entity. If the assets transferred to the FLP were personal, such as the home or vacation place, or if insufficient assets were retained to pay the decedent's expected bills, the Service may apply Section 2036 to include the entire value of the transferred assets in the gross estate.[58] Information about the donor's health and intent and the entity operation will be sought. Family members may be interviewed, as well as medical personnel and legal advisors. Clearly, the examiner is looking for the donor's or the donor's family's motivation to set up the entity, and how much planning and representation of different interests took place.[59] If the donor is in poor health at the time of the entity's inception or dies relatively quickly, the examiner will explore the possible inclusion of the asset under Section 2036. Practitioners representing elderly but healthy clients may wish to obtain and supply medical records documenting the client's good health upon formation of an entity. While there is no obligation for the Service to accept this information, there is no realistic way the Service can counter it.

The examiner will review the entity operations to see if there was a legitimate business operation. Were documents timely created and properly filed? Was there an entity business plan and an independent way to pay the entity's expenses, or did the donor continue to pay bills and take distributions? Did management change, and did the asset mix change?[60]

Even if set up correctly, was the operation of the FLP business-like? Did the manager understand his or her function and fiduciary obligations, or were there unequal distributions? Were assets used for the donor's living expenses? These questions are relevant because the Service may try to develop facts showing an understanding that a donor would continue to have use of the money if needed, thereby triggering section 2036.[61]

The examiner will check to see if business responsibilities were taken seriously (e.g. accountings, decisions recorded, returns filed, contemporary documentation avoiding year-end accounting adjustments, loans, if any, documented and payments made).[62] There are a number of questions asked that are difficult to quantify. Can the estate establish and document a legitimate and significant nontax purpose for the FLP? *Estate of Rosen*[63] and *Estate of Schutt*[64] are instructive in this regard. In Rosen, the Tax Court rejected the estate's after-the-fact standard justifications for establishing the FLP. In contrast, in *Estate of Schutt*, the Tax Court found that a legitimate and significant nontax purpose with evidence documenting fifteen months of planning and meetings to set up the entities with the purpose of preserving shares of DuPont and Exxon.

Were estate taxes or death-related expenses paid from the FLP? Was it dissolved soon after death? *Estate of Rosen*[65] and *Estate of Erickson*[66] are illustrative of how dissolution of the FLP shortly after death and payment of death-related expenses from an FLP can cause inclusion under section 2036. In Rosen, the estate used the FLP's assets to satisfy bequests made in the decedent's trust, pay costs to administer her estate, and satisfy her federal estate tax liability. Similarly, in Erickson, the estate could not pay the decedent's estate and gift tax liabilities, so the personal representative sold the her home to the FLP and made a distribution to the estate "as a redemption" of some of her partnership share. Practitioners should not to wait until the period right before death to make the transfers, to treat loans as business transactions, and to treat distributions from the FLP equally and in proportion to ownership to avoid the result of these cases.

How can you avoid an audit, if possible? One way to lessen the chance of an audit is to supply an independent and well justified appraisal. Practitioners should avoid appraisals from firms that use standard boilerplate language that Service sees repeatedly. For instance, practitioners should avoid using appraisals that drone on about general economic conditions in the country or state and appear to have the name of the entity inserted a few times. A well-written appraisal must discuss the specific ownership interest to be appraised, give the correct valuation date, and a correct description of the property appraised. The appraisal should discuss all agreements, reference previous sales or redemptions, any buy-sell, or right of first refusal.

The appraiser should have credentials that indicate serious study and actual appraisal experience, including: CBA (Certified Business Appraiser from the Institute of Business Appraisers); ASA (Accredited Senior Appraiser issued by the American Society of Appraisers); CPA/ABV (Certified Public Accountant accredited in Business Valuation from the American Institute of Certified Public Accountants); CVA (Certified Valuation Analyst from the National Association of Certified Valuation Analysts); and MAI (Member, Appraisal Institute) and SRA (Senior Residential Appraiser from the Society of Real Estate Appraisers) for real estate and residential appraisals. In Estate of Thompson v. Commissioner, the Second Circuit completely rejected an appraisal of an attorney and accountant due to their lack of membership in any professional appraisal organization. The court stated that the attorney and accountant were "marginally credible" and "barely qualified" to conduct appraisals. Internal Revenue Bulletin 2006-96 defines a qualified appraiser as an individual who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set out in regulations, who regularly performs appraisals for compensation and meets other prescribed requirements including verifiable education and experience in valuing the type of property subject to the appraisal and who has not been prohibited from practicing before the IRS in the three years prior to the appraisal.

An appraiser must consider various valuation methods and indicate why one was rejected or selected. The numbers should add up. In *Lappo v. Commissioner*[69] and *Peracchio v. Commissioner*,[70] the Tax Court cited appraisers for inadequate statistical reasoning. In Lappo, for instance, the Tax Court was critical of the taxpayer's appraiser for using an insufficiently small statistical sample of comparable entities to the FLP appraised. In *Peracchio*, the Tax Court was likewise critical of appraisals that lacked analytical support backed by quantitative analysis. Similarly, in *McCord v. Commissioner*,[71] the Tax Court found that the taxpayer's expert's data did not support the appraiser's conclusions and the Service had more current data.

Many appraisals contain math errors or are not easy to understand. Practitioners should make sure to read through the appraisal for factual errors and understandability. The Service has spent resources on training estate and gift tax attorneys and hiring valuation staff to review and question submitted appraisals and they will not be accepting appraisals that are inadequate or erroneous. When an appraisal amount is determined substantially low, expect penalties to be proposed. Internal Revenue Bulletin 2006-96 adds a penalty for an appraiser whose appraisal results in a substantial or gross valuation misstatement. Penalties that are justified may be added to the estate or gift tax, and are not likely to be abated at the audit or appeals levels.

Practitioners should ask themselves the questions above, and provide answers, if possible, with the return, indicating the legitimate and significant nontax reasons for the FLP's formation. Be realistic. The cases that have gone to trial have generally had discounts of 40% or higher, including discounts of 40% in *Thompson* and *Strangi*, 43.61% in *Korby* and 49% in *Kimbell*.[72] Would your clients really be willing to sell their interests at a 40% discount? If there is family strife or disagreement, that should be brought up in your fact statement. If the assets are liquid and the family is just waiting to liquidate and distribute, the discount amount should reasonably reflect a lack of marketability and control of 10% or less.

IV. Concluding Remarks and Answers to Questions

There were four difficult questions posed at the beginning of this article. First, can a FLP funded primarily with cash and marketable securities have a legitimate and significant nontax purpose? The answer is no in most cases. The Service has been very successful challenging FLPs that consist primarily of cash and marketable securities because the estates have consistently failed to show a legitimate and significant nontax purpose. [73]

Practitioners may be tempted to cite *Schutt* for the proposition that the marketable securities FLP remains viable. While the business trusts in *Schutt* held primarily marketable securities (i.e., DuPont and Exxon stock), the estate had two significant good factors working in its favor. First, the decedent's family made significant contributions of their own funds to legitimately pool their investments in the business trusts. Indeed, the decedent in Schutt made less than half of the contributions. In contrast, the family members in *Abraham*, *Strangi*, *Thompson*, and *Rosen* made *de minimis* contributions in relation to the decedent. Second, the decedent in Schutt followed his long-established conviction for a "buy and hold" investment philosophy. Conversely, the estates in *Abraham*, *Strangi*, *Thompson*, and *Rosen* could not show any such long-established policy.

If a FLP funded primarily with cash and marketable securities cannot normally satisfy the legitimate and significant nontax purpose test, the second question is: What percentage of cash and marketable securities can a FLP hold and still have a legitimate and significant nontax purpose? In Kimball, the decedent funded a FLP with oil and gas interests, which comprised 15% of the FLP's total assets. The remaining assets were cash and marketable securities. Nevertheless, the Fifth Circuit found that the oil and gas interests required active management and the FLP protected the decedent from liabilities associated with such assets. Therefore, practitioners may be tempted to use the Kimbell 15% active assets threshold as a baseline for legitimizing what is ostensibly a marketable securities FLP. Practitioners should concentrate more on minimizing bad factors and ensuring a legitimate business plan than creating a baseline for legitimizing a marketable security FLP.

The third question was: Is there any legitimate and significant nontax purpose for an elderly client in very poor health to form a FLP, especially if the FLP is formed by an attorney-in-fact acting on behalf of such elderly client? The courts in Strangi, Abraham, Rosen, and Erickson have all ruled that an attorney-in-fact forming an FLP for an incapacitated donor fails to serve a legitimate and significant nontax purpose. Such arrangement is not legitimate because the attorney-in-fact (if a beneficiary) stands on both sides of the formation of the FLP. The estates in Strangi, Abraham, Rosen, and Erickson formed marketable securities FLPs and claimed high discounts. The key is to avoid as many bad factors as possible. It is conceivable that an attorney-in-fact could complete formation of a FLP for valid business reasons, which the donor already had in place prior to incapacity. But in the absence of such good facts, formation of an FLP by an attorney-in-fact for elderly and ill donors will not serve a legitimate and significant nontax purpose.

The last question is "do standard justifications for the formation of a FLP such as asset protection, centralized management of assets, and tutelage of the younger generation in investing, create a legitimate and significant nontax purpose?" The courts have uniformly rejected the standard justifications in cases like Strangi, Bongard, Rosen and Erickson. The use of FLPs is not the magic pill that has been sold, perhaps oversold, to unsophisticated clients who proceeded into the land of bad facts. It takes a clearly voiced special need, and not just lawyer's rhetoric, to convince a court that there is a legitimate and significant nontax purpose to the entity. It takes a business, or at least an entity that has a business plan, business goal, and business practices.

Daniel W. Matthews is an Assistant Professor at Thomas M. Cooley Law School where he teaches Taxation, Business Organizations and Wills, Estates and Trusts. He previously had been in private practice and served as a judicial clerk at the U.S. Court of Appeals, Sixth Circuit.

Lorraine New is the sole practitioner of Lorraine F. New P.L.L.C., of Birmingham MI . Previously, she was the manager of IRS Estate and Gift Tax for the state of Michigan. In addition to her active practice, she has served as an expert witness on Gift tax and on fiduciary tax questions, and does estate planning and tax controversies. She has previously been published in the Tax Advisor, the Probate Journal, and Steve Leimberg's national listserve

ENDNOTES

1. Portions of this article were published in a prior edition of the *Michigan Tax Lawyer*. *See* Daniel W. Matthews, *Family Limited Partnerships, Marketable Securities, and Business Purpose: Where Have All The Good Times Gone?* 32 MICH. TAX. LAW. 23 (Winter 2006). These portions are reprinted with the permission of the Editor.
2. ARTHUR SCHOPENHAUER, STUDIES IN PESSIMISM 37 (T. Bailey Saunders, trans., Penn. St. Univ. Press (2005)) (1851).
3. For purposes of this article, the term "FLP" is used generically and is also meant to cover the family limited liability company.
4. *See, e.g., Estate of Strangi v. Commissioner,* 417 F.3d 468 (5th Cir. 2005); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
5. *See Estate of Rosen v. Commissioner,* T.C. Memo 2006-115.
6. Presumably, the Service was loath to litigate such cases, fearing that an unfavorable opinion would only give estate planners ammunition to justify promoting the FLP. Often the fight over discounts simply became a futile fight between valuation experts. The Service may have been apprehensive about cases like *Estate of Dailey v. Commissioner*, T.C. Memo 2001-263, where the Tax Court sided with the taxpayer's expert in upholding a 40% discount for an FLP funded only with marketable securities.
7. 115 T.C. 478 (2000).
8. Treas. Reg. § 20.2036-1(a).
9. *See, e.g., Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145; *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246; *Estate of Harper v. Commissioner*, T.C. Memo 2002-121.
10. See, e.g., *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145.
11. See, e.g., *Estate of Abraham v. Commissioner*, 408 F.3d (1st Cir.), amended by, 429 F.3d 294 (1st Cir. 2005); *Estate of Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Commissioner*, 382 F.3d 367 (3rd Cir. 2004); *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107; *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
12. *Id*.
13. 382 F.3d 367 (3rd Cir. 2004)
14. 417 F.3d 468 (5th Cir. 2005) ("*Strangi III*"). On November 7, 2005, the Fifth Circuit granted a petition for rehearing and remanded the case to the Tax Court for the limited purpose of determining allowable administrative expenses, including attorney's fees. 2005 U.S. App. LEXIS 24016; 96 A.F.T.R.2d (RIA) 6895 (5th Cir.).
15. 408 F.3d 26 (1st Cir.), *amended by*, 429 F.3d 294 (1st Cir. 2005).
16. T.C. Memo 2006-115.
17. T.C. Memo 2007-107.
18. T.C. Memo 2005-102 (wife's estate) and T.C. Memo 2005-103 (husband's estate).
19. T.C. Memo 2006-34.
20. 382 F.3d 367 (3rd Cir. 2004)
21. *Estate of Thompson*, 382 F.3d at 376.
22. *Id*.
23. *Id*.
24. *Id*. at 383.
25. *Id*. at 379.
26. *Id*. at 380.
27. *Id*.
28. 417 F.3d 468 (5th Cir. 2005) ("*Strangi III*"). On November 7, 2005, the Fifth Circuit granted a petition for rehearing and remanded the case to the Tax Court for the limited purpose of determining allowable administrative expenses, including attorney's fees. 2005 U.S. App. LEXIS 24016; 96 A.F.T.R.2d (RIA) 6895 (5th Cir.).
29. *Strangi III*, 417 at 474 &n.2. The estate reported a value of $6,560,730 for the limited partnership. Upon audit, the Service denied the discount and included the $10,947,343 value of the assets transferred for the limited partnership interest.
30. Strangi III, 417 F.3d at 478.
31. *Id*. at 479.
32. *Id*. at 480.
33. *Id*. at 480-81.
34. *Id*. at 481.
35. *Id*. at 481-82.
36. 408 F.3d 26 (1st Cir.), amended by, 429 F.3d 294 (1st Cir. 2005).
37. T.C. Memo 2006-115, 2006 Tax Ct. Memo LEXIS 116.
38. *Id*. 2006 Tax Ct. Memo LEXIS 116 at 53.
39. T.C. Memo 2007-107.
40. T.C. Memo 2005-102 (wife's estate) and T.C. Memo 2005-103 (husband's estate).
41. T.C. Memo 2006-34.
42. 371 F.3d 257 (5th Cir. 2004).
43. *Kimbell*, 371 F.3d at 260.
44. *Id*. at 262, 265.
45. *Id*. at 265.
46. *Id*.
47. *Id*. at 266.
48. *Id*.
49. *Id*. at 266.
50. *Id*. at 267.
51. *Id*. at 269.

52. 124 T.C. 95 (2005).
53. *Estate of Bongard*, 124 T.C. at 118.
54. *Id*. at 119-121, 123.
55. *Id*. at 122-23.
56. *Id*. at 130.
57. T.C. Memo 2005-126.
58. *See, e.g., Estate of Rosen v. Commissioner*, T.C. Memo 2006-115; *Estate of Disbrow v. Commissioner*, T.C. Memo 2006-34; *Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, aff'd 408 F.3d 26 (1st Cir. 2005); *Estate of Harper v. Commissioner*, T.C. Memo 2002-121.
59. *See, e.g., Estate of Bongard v. Commissioner*, 144 T.C. 95 (2005); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115; *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126.
60. *See, e.g., Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, T.C. Memo 2002-121, *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242.
61. See, e.g., *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115, *Estate of Korby v. Commissioner*, T.C. Memo 2005-102; *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65.
62. *See, e.g., Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115; *Estate of Disbrow v. Commissioner*, T.C. Memo 2006-34; Estate of *Bigelow v. Commissioner*, T.C. Memo 2005-65.
63. *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
64. *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126.
65. *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
66. *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107; *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
67. 2007 U.S. App. LEXIS 20066.
68. *Id*. at 16.
69. *Lappo v. Commissioner*, T.C. Memo 2003-258.
70. *Peracchio v. Commissioner*, T.C. Memo 2003-280.
71. 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006).
72. *Estate of Thompson v. Commissioner,* 382 F.3d 367, 372 (3rd Cir. 2004); *Estate of Strangi v. Commissioner*, 417 F.3d 468, 474 & n.2 (5th Cir. 2005); *Estate of Korby v. Commissioner*, T.C. Memo 2005-102, 2005 Tax Ct. Memo LEXIS 103, 7; and *Kimbell v. United States*, 371 F.3d 257, 260 (5th Cir. 2004).
73. *See, e.g.*, *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107; *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.

CIRCLING SHARKS: TOWARD A BETTER UNDERSTANDING OF THE TAX LAWYER'S ROLE UNDER CIRCULAR 230, FIN 48 AND THE WORK-PRODUCT DOCTRINE

Paul McCord

Beware pendulum swings. Between 1997 and 2002, the IRS drew down its enforcement resources significantly and cut revenue agents by more than a quarter. Audit rates declined, as did criminal prosecutions and enforcement revenues. Then, with the collapse of Enron in late 2001 and the disclosure of other corporate and financial irregularities in early 2002 led to the enactment of the Sarbanes-Oxley Act of 2002 ("SOX"). That same year, the IRS issued Announcement 2002-63, which is part of the IRS's effort to identify and crack down on abusive tax shelters, signaled a more aggressive approach by the government to requesting and summoning tax accrual workpapers.[1] Shortly thereafter what is now FIN 48 can be traced to a December 2003 speech at the AICPA Conference on SEC Developments, where an SEC staff member expressed concern about the application of FAS 109 to "tax advantaged transactions," and questioned whether tax assets should be recognized when the benefit may not be realized. In a March 2004 roundtable discussion involving representatives of the Big Four accounting firms, SEC, and FASB staff, the participants discerned significant "diversity in practice" in the recognition of tax benefits associated with aggressive transactions.[2] These developments were followed by significant revisions to Circular 230 and Schedule M. The confluence of these legislative, regulatory, and enforcement events is a significant development in the movement toward transparency in both financial accounting and tax reporting. The most significant issue currently on the agenda of the tax departments is determining how to handle the sudden new demands of FIN 48, FAS 109, SOX, and Circular 230. Arguably, legal opinions and memoranda prepared for a taxpayer to help document its tax reserve determinations under FIN 48 may be viewed as tax accrual workpapers. The preparation of a legal opinion or memorandum that documents compliance with the recognition or measurement step of FIN 48 raises questions about the availability of the attorney-client and work-product privilege. The movement toward transparency, in turn, will continue to test the limits of privilege claims. As a result, accountants, lawyers and clients may find themselves re-examining and possibly redefining their roles in the tax and audit processes as lines in the sand are drawn.

FIN 48

FAS 109 describes the objective of accounting for income taxes as recognizing "(a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns." FAS 109 also recognize the following four "basic principles of accounting for income taxes":

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

FAS 109 provides no guidance, however, on how to take uncertainties into account when determining "estimated taxes" and "estimated future tax effects." Owing to this lack of guidance, the FASB has observed that "diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in no comparability in reporting income tax assets and liabilities."

Scope of Application

FIN 48 applies to all companies that account for tax positions in accordance with FAS 109, i.e., any company with audited financial statements--including pass-through entities and nonprofit organizations if they are subject to tax. It applies to state, local, and foreign income taxes as well as federal income taxes. As a technical matter, it applies to all tax positions, regardless of whether they are "uncertain."[4] FIN 48 does state, however, that the FASB "does not anticipate that this Interpretation will have a significant effect on how enterprises account for tax positions that are routine business transactions that are clearly more likely than not of being sustained at their full amounts upon examination."[5] As a practical matter, FIN 48 is likely to affect the functioning of the tax department only with respect to tax positions that involve significant uncertainty.

The More-Likely-Than-Not Recognition Standard

In order to report the benefit of a tax position on a company's financial statement, the company generally must determine that it is more likely than not that the position will be sustained, based on the technical merits of the position, if the taxing authority examines the position and the dispute is litigated to the court of last resort.[6] The determination is made on the basis of all the facts, circumstances, and information available as of the reporting date. In applying the more-likely-than-not standard to a tax position, a company must assume that the position will be examined by the relevant taxing authority and that the authority will have knowledge of all relevant facts.[7]

The more-likely-than-not threshold for recognition under FIN 48 coincides with (1) the confidence level required by section 6664(d)(2)(C) of the Internal Revenue Code under the "reasonable cause" exception to the reportable transaction penalty under section 6662A and (2) the comfort level that, under IRS Circular 230 (relating to "practice before the IRS"), may cause a tax opinion to be considered a "reliance opinion."[8] Circular 230 requires rigorous due-diligence and opinion-drafting procedures. The full panoply of these procedures generally is not required by the Internal Revenue Service where an opinion that (1) is prepared solely to evaluate the merits of a position taken on an already-filed return,[9] or (2) is not intended to be used by the company for the purpose of avoiding potential tax penalties and contains appropriate disclaimer language to that effect.[10] Many tax counsel believe, however, that a significant subset of those procedures is required in appropriate cases as a matter of sound legal practice. Moreover, auditors may question the value of an opinion supporting recognition of a tax position if the Circular 230 Procedures are not followed. Accordingly, when requesting an opinion from counsel, a company should consider advance discussions both with counsel and with the company's auditors on the procedures to be followed by counsel in preparing the opinion.

In a departure from the foregoing requirement of an "on the merits" determination, FIN 48 states that companies may take administrative practices of taxing authorities into account (in addition to legal authorities) as long as those practices are "widely understood."[11] The Minutes of the FASB's May 10, 2006, meeting provide that the "administrative practices" concept generally is "intended to deal with a limited number of tax positions that are technical violations of the tax law for which it is broadly understood that the taxing authorities, with access to all relevant facts, would not object."[12] A company's auditors will generally expect to review opinions supporting the company's tax positions, but the auditors will be unable to prepare such opinions absent audit-committee approval in accordance with Sarbanes-Oxley protocols.

Effect on Tax Departments

Under the FIN 48 regime, tax departments will need to implement processes to handle the following matters on an ongoing basis:

- Since management will need to justify its decisions to recognize benefits from tax positions under the recognition standard and measurement principles of FIN 48, tax departments will need to (1) adopt procedures for determining the "unit of account" (i.e., the appropriate level of disaggregation)[13] for analyzing tax positions, (2) adopt procedures for identifying tax positions with sufficient uncertainty to warrant a full-fledged FIN 48 analysis, (3) document the analysis warranting each determination that a particular uncertain position is more likely than not to be sustained, (4) document the methodology applied to measure the recognized benefit from each uncertain tax position, and (5) document the methodology used to calculate interest expense with respect to each unrecognized tax benefit.

- Since changes in circumstances may necessitate recognition, derecognition, or remeasurement of benefits from tax positions taken in prior-period returns, tax departments will need to maintain an inventory of all tax positions with a significant degree of uncertainty (even if the benefits from such positions were fully recognized), except tax positions that are outside the applicable statute of limitations.

- Because FIN 48 may increase the likelihood that tax benefits from transactions will not be recognized, tax departments will want to apply a "FIN 48 filter" to contemplated transactions with significant tax uncertainties so that decisions not to recognize tax benefits do not come as a surprise to management.

The Role of Outside Tax Counsel

The implications of FIN 48 for law firms, as well as accounting firms, are significant. Law firms frequently give risk assessments to clients regarding uncertain tax positions and the FASB concluded that "a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law."[14] Although a tax opinion is not technically required to justify the decision to recognize a tax benefit, there are many circumstances in which an unqualified more-likely-than-not opinion from outside counsel will be valuable to a company's management and/or its tax department. Under FIN 48, tax departments will need to document a refined decision process for the recognition and measurement of the tax benefits of all tax positions. Where a tax position involves any significant amount of uncertainty, an outside opinion often will be the tax director's or CFO's best choice for documenting a decision to recognize all or part of the benefits from the position.

In the sunshine of the current day (i.e., post-Sarbanes-Oxley, FIN 48, IRS transparency in tax reporting), outside auditors may ask to see such opinions. Such requests by auditors present issues of privilege waiver, as well as liability for the law firms if the client claims to rely upon the opinion in formulating financial statements. And, of course, it is not unforeseeable that the client may choose to show the opinion to the auditor to support the position taken on the financials, without regard to privilege waiver issues.

Further, it is also interesting that the "more likely than not" standard is often used to avoid penalties under the "accuracy related" penalty provisions of the Internal Revenue Code, and such "reliance opinions" are governed by Treasury Circular 230 (unless reliance by the taxpayer is expressly disclaimed in the opinion). If not disclaimed, stringent procedures outlined in Circular 230 must be followed. Thus, the role of the law firm in giving risk assessments for uncertain tax opinions, and the uses of such opinions by the client, is an emerging area.

Nevertheless, investment in legal services to support financial statement recognition of a company's tax positions will provide dual benefits. In addition to supporting the company's financial reporting, contemporaneous analysis of uncertain tax positions and written documentation of that analysis will likely reduce the cost of future tax audits.

ABA Task Force Report and Resolution

Both the accounting and legal professions recognize that the increasing scrutiny of the tax reserves means performing a more careful analysis of the presentation of the reserves and the content of the workpaper files behind them. They differ, however, as to what documents must be included in tax accrual workpaper files. The *ABA Task Force Report and Recommendation to the ABA House of Delegates on Audit Issues*, adopted Aug. 8, 2006, identifies the information that the ABA believes may properly be required in an audit without undermining attorney-client[15] and work-product[16] protections, and calls on federal regulators and the accounting and legal professions to make clear "what information auditors need, and more importantly do not need, for the proper conduct of the audit."[17]

Transparency in Tax Reporting

Complying with tax return reporting rules is more difficult and costlier than ever before. Federal reportable transactions must be disclosed and reported correctly, or severe penalties may be imposed. This is the case even if the reporting error does not affect the taxpayer's current tax liability, such as when a corporation reports a net operating loss. These disclosure rules are continually changing—for example, in January 2006, the IRS announced that for most 2006 year returns, transactions with a "significant" book-tax difference will no longer be classified as a reportable transaction, although proper disclosure on Schedule M-3 will still be required.[18]

The financial accounting transparency has its counterpart in tax reporting, including Schedule M-3,[19] "reportable transactions" compliance[20] and increased IRS enforcement and audit activity. In June 2006, IRS Commissioner Mark Everson testified before the Senate Committee on Finance on how the IRS was achieving that transparency: "The Schedule M-3 provides transaction-specific detail on book-tax differences, enabling us to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk."[21] Further to this point, on July 12, 2006, the IRS announced that examinations of more than 200 tax returns would be made simply based on Schedules M-3 filed by those taxpayers.[22]

IRS Summons for Tax Accrual Workpapers and Tax Opinions

Further, the IRS may be stepping up its requests for tax accrual workpapers[23] and tax opinions despite taxpayer objections. While more than 20 years ago the Supreme Court affirmed the IRS' right to obtain tax accrual workpapers,[24] soon thereafter the IRS announced a policy of voluntary restraint with procedural safeguards, stating: "The Service will continue its current policy of requesting Tax Accrual Workpapers only in unusual circumstances."[25] However, recent revisions to that policy in the wake of so-called "abusive tax shelters" have placed the IRS' rights and methods center stage again. In 2002, the IRS announced that it will routinely request all of a taxpayer's tax accrual workpapers if a so-called "listed transaction"[26] is not properly disclosed on a return, or if tax benefits from multiple listed transactions are claimed on the return, regardless of whether or not they are disclosed.[27] Prior to this change in policy, the IRS had requested tax accrual workpapers a total of five times in 30 years.[28] In fiscal year 2005 alone, the IRS submitted 50 requests for tax accrual workpapers.[29] Presumably these requests were made in accordance with the policy set forth in Announcement 2002-63. However, in a speech at a conference of tax executives in the fall of 2005, Deborah Butler, IRS Associate Chief Counsel (Procedure and Administration), discussed a limited expansion of the policy set forth in Announcement 2002-63, but offered no further detail. She did say that the limited change aims for more transparency in examining workpapers.[30]

While the IRS insisted that it is no moving away from its policy of restraint,[31] the IRS plans to continue issuing summonses and requests for tax accrual workpapers in cases where taxpayers refuse to turn over information based on privilege claims.[32] Despite assurances that requests for tax accrual workpapers by the IRS will be limited to so-called abusive transactions, there may be cause for concern as the IRS moves for more transparency in its examinations and erodes at its policy of restraint.

Further the implementation of FIN 48 creates additional problems for privilege claims with respect to tax advice. The technical positions underlying the tax benefit may need to be documented and analyzed using the "more likely than not" standard. If the advice is placed in the tax accrual workpapers to satisfy the auditor, the privilege may be irretrievably lost. Furthermore, pressure from SOX 404 is causing auditors to ask for legal memoranda, tax opinion letters and other potentially privileged documents supporting a company's tax reserve position. And the IRS is no longer reticent about requesting the tax accrual workpapers. However, recent IRS' recent setbacks in Roxworthy and Textron should prompt companies to revisit the manner by which they handle the creation, management and production to third parties of documents comprising tax accrual workpapers and FIN 48 supporting documentation. Both Yum and Textron succeeded in protecting the confidentiality of their tax accrual workpapers under the work-product doctrine.

Roxworthy

We are perhaps fortunate to practice within the Six Circuit given that Court's recent holding in *United States v Roxworthy.*[33] Before *Roxworthy*, the Sixth Circuit had not as of that point had the occasion to define the meaning of "in anticipation of litigation" in the context of the work-product doctrine. The Roxworthy Court held that documents are prepared in anticipation of litigation when they are "prepared or obtained because of the prospect of litigation."[34] The decision by the U.S. Court of Appeals for the Sixth Circuit in *Roxworthy* reassures the validity of a work-product privilege claim for tax advice before an audit commences. *Roxworthy* is particularly significant to taxpayers and tax advisers because it adopts the analysis of the Second Circuit in *Aldman II*[35] by holding that the documents at issue were covered by the work-product doctrine.[36]

Summary of the Case

In *Roxworthy* two memoranda were prepared by KPMG LLP for the general counsel of Yum! Brands, Inc, analyzing creation of a captive insurance company and related stock transfers. The IRS issued an information document request (or IDR's) in the course of its audit of Yum's 1997, 1998 and 1999 tax years. In response, Yum asserted privilege for seven documents including the two memoranda it believed were protected under the work-product doctrine. The IRS then issued a summons to Patrick Roxworthy, Yum's Vice-President, Tax, for the documents on the privilege log. After entering into a limitation of waiver agreement, Yum produced five of the seven documents.

When the two KPMG memoranda were not produced, the IRS brought a summons enforcement action in district court. The district court ultimately concluded that the summons should be enforced on the ground that the documents were created to assist Yum in connection with preparation of its tax return and not "in anticipation of litigation." Yum appealed.

The Sixth Circuit followed *Adlman II* in defining documents prepared "in anticipation of litigation" as "prepared or obtained because of the prospect of litigation" and found that the work-product doctrine protected the two memoranda because the taxpayer established, based on surrounding facts and circumstances in addition to the substance of the documents themselves, that the documents were prepared in anticipation of litigation. In particular, the court found that the work-product doctrine could protect a document prepared before the issue was raised on audit and even before the return was filed; the court, however, expressly declined to rule that the taxpayer's anticipation of an audit was sufficient to trigger the doctrine.[37]

Textron

More recently, *United States v Textron Inc*,[38] the United States District Court for the District of Rhode Island denied an IRS petition for enforcement of a summons requesting a taxpayer's tax accrual workpapers because the workpapers were protected by the work-product privilege. The federal district court held that the taxpayer waived the otherwise applicable attorney–client and tax practitioner–client privileges when it provided the workpapers to its independent auditors for examination as part of their audit.

Textron Facts

In conjunction with Textron's preparation of its audited financial statements to be filed with the Securities and Exchange Commission (SEC), Textron's in-house counsel prepared "workpapers"[40] that contained counsel's opinions regarding positions that Textron anticipated to be challenged by the IRS. Textron prepared its tax accrual workpapers for the purpose of determining its reserve for contingent liabilities under GAAP in conjunction with the issuance of its financial statements, which were to be audited by Ernst & Young (E&Y) and filed with the SEC. [41]

The IRS issued an administrative summons to Textron seeking its workpapers for the 2001 tax year. The summons sought not only the workpapers relating to the remaining issue on audit (involving what is commonly known as a SILO, Sale-In Lease-Out, transaction) but all tax accrual workpapers for the 2001 tax year. In issuing the broad request for tax accrual workpapers, the IRS was implementing its current tax accrual workpaper policy, as described in Announcement 2002-63, which requires an examining agent to request workpapers relating to a listed transaction entered into by the taxpayer under audit, and, in the case of multiple listed transactions entered into by the taxpayer, all tax accrual workpapers for the relevant tax years.

The summons came on the heels of an extended audit of Textron's 1998-2001 tax years in which more than 500 Information Document Requests (IDRs) were issued by the examining agents. Textron responded to all other IDRs, but refused to respond to an IDR seeking the tax accrual workpapers, and so the IRS backed up the IDR with an administrative summons. The focus of the summons was on the workpapers of Textron, Inc., the parent company, and one of its subsidiaries, Textron Financial Corporation or TFC.

Textron took the position that the workpapers were protected from disclosure under the attorney-client privilege, the tax practitioner privilege[42] and the work product doctrine.[43] Specifically, with respect to Textron's work-product claims, Textron asserted that it prepared its workpapers in anticipation of litigation with the IRS regarding various items on its return. Textron pointed to the hazards of litigation percentages contained in its workpapers to support this assertion. The IRS countered that Textron's workpapers were prepared in the ordinary course of business and to comply with GAAP (which mandate the creation of tax reserves to meet contingent liabilities).

District Court's decision in Textron

The district court held that Textron's workpapers were the work-product of its attorneys and, therefore, not discoverable. The district court found that Textron created the workpapers to determine adequate reserves in case of later controversy or litigation. The court also found that the workpapers served the purpose of showing Textron's outside auditors, Ernst & Young that its reserves were appropriate and thereby facilitating E&Y's approval of the audited financial statements. The district court held that the workpapers in question were protected attorney work product because they contained the opinions of Textron's counsel and accountants related to: (1) items that might be challenged by the IRS; (2) estimated hazards of litigation percentages; and (3) calculation of tax reserve amounts that would not have been prepared "but for" the fact that Textron anticipated the possibility of litigation of these issues with the IRS. The court also found that Textron would not have needed its tax accrual workpapers and would not have had a tax reserve if it had not anticipated a dispute with the IRS. Moreover, there was no question in the court's mind, given that, in seven out of Textron's previous eight audit cycles, Textron had appealed unresolved audit issues—three of which were resolved in federal court, Textron reasonably anticipated a dispute with respect to the return positions reflected in the workpapers. The court rejected the IRS's argument that the workpapers were really created in the ordinary course of business for financial accounting purposes and, as a result, enjoyed no protection. Following the majority of circuits, the court reasoned that a document might be used for business reasons, such as for financial accounting requirements, while still retaining work product status.

Further, the court, following the trend in cases dealing with disclosure to outside auditors, held that Textron did not waive its work-product protection by sharing the workpapers with E&Y.[44] The question of waiver of work product, unlike waiver of privilege, is not settled merely by determining that the document was shown to a third party. A further question must be asked: whether the disclosure substantially increases the opportunity for a potential adversary to obtain the document. Several recent district court cases have examined the issue and concluded that an outside auditor who receives or reviews documents such as internal reserve estimations does not break the work product protection. While an auditor may have an independent duty as regards its public accounting role, this does not mean information it has received is thereby public information. In fact, as noted by the court, E&Y was bound by a professional code of conduct to maintain the confidentiality of Textron's information and was separately bound to confidentiality by way of its engagement with Textron. Thus, the disclosure of the workpapers to E&Y did not waive work product.

Nor did the IRS establish a "substantial need" to warrant the production of protected work-product. The court held that the IRS was unable to demonstrate a "substantial need" for the workpapers. The workpapers contained opinions and conclusions of Textron's tax counsel, which would have little bearing on the determination of Textron's tax liability. Further, the workpapers did not contain any factual information that could not be obtained from Textron's tax returns, and disclosure of Textron's counsel's opinions would unfairly disadvantage Textron in the event of any dispute that might arise with the IRS.

IMPLICATIONS AND LESSONS LEARNED FROM *ROXWORTHY* AND *TEXTRON*

Less may be more. *Roxworthy* involved only two documents (and the original privilege log included only seven documents), Textron involve only a handful documents out of over 500 requested, reminding us that in a privilege fight less usually is more. Although there may be many sensitive documents in the tax reserve file, taxpayers and advisers should carefully review each document and assert a work-product claim only for those documents for which they can make a showing that the document was prepared in anticipation of litigation or controversy. To be sure, there is always the temptation to withhold all documents that include any assessment of likely outcomes in audit workpapers, but the reality of privilege is that many documents cannot satisfy the "prepared in anticipation of litigation" standard and thus are not protected under the work-product doctrine. It may be difficult for a taxpayer to prove that all of its tax accrual workpapers were prepared in anticipation of litigation and not just in the ordinary course of business. For this reason, some commentators have suggested that a corporation should have its legal memoranda prepared to independently analyze the reserve for specific corporate transactions, and that such legal memoranda should be segregated from the aggregate tax contingency reserve documentation in order to preserve the protection of the memoranda under the work-product doctrine.[45] Claiming work-product protection for documents without strong evidence of "anticipation of litigation" may cause a court to view all of the privilege claims skeptically. By overreaching, taxpayers can jeopardize those documents for which they may have strong claims.

As noted by the court in *Textron*, tax accrual workpapers should be limited to confidential information. Work product is determined on a document-by-document basis, so to the extent documents included in the tax accrual workpapers consist of factual information, they are unlikely to be protected.

Both the district court in *Textron* and the Sixth Circuit in *Roxworthy* considered both the content of the memoranda (that they discussed the strengths and weaknesses of the taxpayer's case) and also the circumstances under which the memoranda were prepared. In finding that Yum had demonstrated that the documents really were prepared in anticipation of litigation, despite the lack of any "overt" indication that the IRS would pursue litigation against Yum, the Sixth Circuit enumerated four key facts that Yum had established: "[1] a specific transaction that could precipitate litigation, [2] the specific legal controversy that would be at issue in the litigation, [3] the opposing party's opportunity to discover the facts that would give rise to the litigation, and [4] the opposing party's general inclination to purse this sort of litigation."[46] The court also took note of the memoranda's "highly detailed discussions of hypothetical legal arguments."[47] This provides a convenient roadmap for taxpayers seeking to sustain a work-product privilege claim. To strengthen a potential claim, taxpayers should contemporaneously document the elements identified by the court in *Roxworthy* and *Textron*.

Although the *Roxworthy* case emphasizes the importance of facts, the opinion does not fully address how much proof is required to sustain a work-product claim. For example, in the case of a Coordinated Industry Case (CIC) taxpayer that is continually under audit, it goes without saying that the IRS has a higher likelihood of discovering the transaction and the taxpayer a higher risk of litigation. In *Textron* the court reasoned that had Textron determined that here was no risk of litigation for a particular return position, no tax accrual workpaper would have been created with respect to that position.[48] This is an important aspect of the court's work product analysis because if the workpapers had been created without regard to the potential for litigation, there would likely be no work-product protection.

The Sixth Circuit in *Roxworthy* emphasized the role of Yum's general counsel in obtaining the tax advice and assessing litigation risks generally for the company. The district court in *Textron* also noted the role of Textron's in-house counsel in preparing the workpapers as issue. It is unclear whether the court would have reached a different conclusion had the advice been obtained by the tax director. As long as the taxpayer can show that the tax director anticipated litigation or controversy with the IRS, sought advice because of the anticipated litigation or controversy, and would not have sought the advice (or at least not in the same form) in the absence of the anticipated litigation or controversy, a court should sustain a work-product claim.

Also relevant is the legal standard in the relevant jurisdiction determining whether a document was created in anticipation of litigation. As the *Textron* court stated, depending on the jurisdiction, courts apply either the "primary purpose" or the "because of" test in applying the work product doctrine. Under the "primary purpose" test, a document is protected from disclosure "'as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation.'"[49] Under the more inclusive "because of" test, adopted by the Six Circuit in *Roxworthy* and applied by the district court in Textron, a document is protected if "the document was prepared or obtained 'because of' the prospect of litigation.'"[50] Determining what qualifies as work product in the relevant jurisdiction is the first step to preserving its confidentiality.

As noted in *Textron*, taxpayers should obtain a signed nondisclosure letter from the auditor acknowledging the receipt of, and the duty to keep confidential, information that is protected work product. The primary consideration in obtaining a "nondisclosure letter" with an outside auditor is to anticipate, and protect against, future arguments by governmental agencies or other third parties that the information is not protected work product or that such protection has been waived. Textron reviewed the information with its auditors only after reaching agreement as to maintaining its confidentiality, and its auditors were not permitted to retain a copy. When the IRS audit concluded, the tax accrual workpapers "would be locked away in a locked cabinet."

Further, as *Textron* did, companies should give careful thought in adopting document control protocols that are consistent with their business practices and take into consideration the importance of maintaining physical segregation of tax accrual workpapers and ensuring limited accessibility.

Conclusion

The *Roxworthy* and *Textron* decisions might have implications regarding whether the IRS or state tax authorities can successfully compel disclosure of internal FIN 48 workpapers. As discussed, FIN 48 requires a determination that an uncertain tax return position has a more likely than not chance of prevailing in order to book the tax benefit. Reasoning similar to that of the *Roxworthy* or *Textron* courts could apply inasmuch as, for example, it is unlikely any FIN 48 workpapers would be created if the taxpayer believed its return positions were not uncertain. In other words, FIN 48 workpapers are created specifically for those return positions for which the outcome is uncertain and with respect to which the taxpayer anticipates litigation with the IRS, similar to Textron's list of positions for which the law was "unclear." Absent some protection or privilege, a taxing authority may be able to compel a taxpayer to produce its FIN 48 workpapers.

While the IRS policy remains one of self-restraint concerning requests for tax accrual workpapers, with requests generally made only in connection with listed transactions or in cases involving unusual circumstances, e.g., in the case of a restatement of earnings. Notwithstanding the current policy of restraint, the IRS has indicated that it intends to revisit this policy as appropriate, and it is possible that changes may be made in connection with the examination of tiered issues and/or transactions of interest. All indications are that the government will continue to inquire into taxpayers' analyses of their tax positions. Current indications are that the IRS will appeal *Textron*.[51] The IRS is increasingly asking for "workpapers" in the context of IRS audits involving "Tier 1" issues. For example, a recent Tier 1 issue standard IDR seeks all "accounting or legal advice, studies or opinions." The IRS may seek similar information from the taxpayer's accountant through a third-party summons. In this same context, the IRS has implemented a robust training program for Examination agents on interpreting the details of companies FIN 48 disclosures.

The IRS is not the only government entity that has indicated an interest in corporate analyses of tax positions. The rationale of *Roxworthy* and *Textron* may also be extended to apply to requests for production of documents by state and local taxing authorities. Just like the IRS, many state departments of revenue have become much more aggressive in seeking taxpayers' internal workpapers. The Multistate Tax Commission has recently stated that it is exploring how state taxing authorities might obtain and utilize the wealth of detailed information contained in taxpayers' FIN 48 workpapers. Many states' laws on work product are similar to the federal principles applied in *Roxworthy* and *Textron*, and some provide protection that is arguably even broader than that available under federal law. Because many FIN 48 issues involve "uncertain" multistate tax positions, Roxworthy and Textron provide a valuable road map for multistate taxpayers to protect their workpapers under certain circumstances.

Paul V. McCord, practices federal and state and local tax at Varnum, Riddering, Schmidt & Howlett. Mr. McCord holds an LL.M. from Georgetown University Law Center, a J.D. from the University of Illinois College of Law, and a B.S. from Marquette University.

ENDNOTES

1. Tax accrual workpapers (defined in Chief Counsel Notice 2004-10) are not privileged. These include all workpapers relating to reserves for current, deferred, and potential tax liabilities.
2. Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") requires companies to establish effective internal controls over their tax department that are approved by the company's outside auditor. According a report prepared by Ernst & Young, half of the companies that reported material weaknesses in tax controls had to restate their tax accounts because of errors by the tax function. The most frequent error was accounting for deferred taxes under FASB Statement No. 109 ("FAS 109"), which generally addresses accounting for income taxes. On July 13, 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48 ("FIN 48"), which addresses accounting for uncertainty in income taxes. FIN 48 is an interpretation of FAS 109. Prior to the adoption of the interpretation, FAS 109 did not prescribe a threshold that had to be met before the benefit of an uncertain tax position could be recognized for financial statement purposes. FIN 48 is intended to clarify the financial accounting for uncertainty in income taxes.
3. FIN 48 ¶ 1.
4. FIN 48 ¶ 4 and ¶ B10-12.
5. FIN 48 ¶ B12.
6. FIN ¶¶7 and A2.
7. FIN 48 ¶ 7(a).
8. Circular 230, § 10.35(b)(4)(i).
9. Circular 230, § 10.35(b)(2)(ii)(C).
10. Circular 230, § 10.35(b)(4)(ii).
11. FIN 48 ¶ 7(c), ¶¶ A12-A15.
12. One example provided by FIN 48 involves a taxing authority's practice of not objecting to a capitalization threshold (i.e., a company's practice of expensing all items purchased for less than $x). FIN 48 ¶¶ A12-13. Another example provided involves a company that has been doing business in two jurisdictions for 50 years and 20 years, respectively, and has filed tax returns with those jurisdictions for each of those years. FIN 48 ¶¶ A14-15. Although the company is not certain that it was not doing business in those jurisdictions before the years in which it filed returns, and although the statutes of limitations do not begin to run until returns are filed, it is a widely understood administrative practice of one of those jurisdictions (Jurisdiction B) to look back only six years in examining open years. The example does not provide an express conclusion, but it suggests that the company may properly conclude that it is more likely than not that a return is not required to be filed in Jurisdiction B for any open year. No such conclusion is justified, however, for the other jurisdiction.
13. In applying FIN 48, it is necessary to determine the appropriate "unit of account" for a tax position. In other words, each tax position may need to be broken down into individual tax issues. It is not clear how finely companies will have to disaggregate tax positions to reflect possible discrete challenges by the IRS and/or other tax authorities. Presumably, if the firm uses reasonable judgment in anticipating the approach the tax authority will take during an examination, it will be deemed in compliance with FIN 48. In making this determination, the firm should consider the manner in which it prepares and supports its tax return and it should anticipate the approach the tax authority will take during an examination. One valuable source of information in this regard may be the approach taken by the tax authority in the firm's prior audits or, if known, of similar companies within the industry. For example, suppose a firm claims a $1 million research and development credit on its tax return. It is possible that the entire credit claim is a single "unit of account," and thus a tax position that requires evaluation. Alternatively, it is possible that various aspects of the credit may be separately evaluated. So, if the credit claim relates to two separate projects, then it is possible that each project will need to be evaluated separately to determine if the associated expenditures qualify. If the taxpayer believes that the tax authority will evaluate the credit in that manner, then the "more likely than not" test should be applied to each project. But if only one project meets the test, then all expenditures associated with the other project would not result in any tax benefit. It is also possible that the government might look separately at other issues, such as whether senior personnel whose wages were treated as qualifying expenditures participated in the research activity or directly supervised it.
14. FIN 48 ¶ B34.
15. The attorney–client privilege protects confidential communications between an attorney and client relating to legal advice sought from the attorney for the purpose of encouraging full and frank discussion necessary to provide the client with sound legal advice.
16. The work product doctrine applies to material prepared or gathered by an attorney "in anticipation of litigation" or preparation for trial and in certain instances may be invoked with respect to an IRS summons. Unlike the purpose of the attorney–client privilege, which is to encourage free communication between a client and counsel, work product protection is designed to prevent a potential adversary from discovering a party's strategy or the party's own assessment of the strengths and weaknesses of its case. There are two tests to determine whether material was prepared or gathered "in anticipation of litigation." The first is the "primary purpose" test, which requires that the primary motivating purpose behind the creation of the document was to aid possible future litigation. The second test is the "because of" test, which requires that the document be prepared or obtained because of the prospect of litigation. Work product protection is qualified and generally may be overcome if the opposing party establishes a "substantial need" for the protected documents or that the information contained in the protected documents (or their substantial equivalent) cannot be obtained without undue hardship. Additionally, the protection may be waived if the material in question is disclosed in a way that is inconsistent with the purpose of keeping it from an adversary.
17. See *ABA Task Force Report and Recommendation to the ABA House of Delegates on Audit Issues as Adopted, August 2006*, is available at *www.abanet.org/buslaw/attorney client/home.shtml.*
18. Notice 2006-6, 2006-5 I.R.B. 385. If the transaction must be reported for some other reason, e.g., it produces a large loss, and then the transaction must still be disclosed on Form 8886.
19. The IRS unveiled final drafts of Schedules M-3 (Net Income

(Loss) Reconciliation) and related forms for the 2006 tax year on July 20, 2006. The final draft schedules were for Forms 1120, 1120-L, 1120-PC, 1120S, and 1065.
20. See Reg §1.6011-4.
21. IRS News Release IR-2006-94 (June 13, 2006), Written Testimony of Commissioner of Internal Revenue Mark Everson before Senate Finance Committee on Compliance Concerns Relative to Large and Mid-Size Businesses.
22. Crystal Tandon, *More Than 200 Returns Targeted on Basis of Schedule M-3 Data, IRS Official Says, 2006* TNT 133-4 (July 12, 2006).
23. The IRS defines the term "tax accrual workpapers" as "those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis or tax contingency reserve analysis." IRM 4.10.20.2(2) (07-12-2004).
24. *United States v Arthur Young & Co*, 465 US 805 (1984).
25. Announcement 84-46, 1984-18 IRB 18. In 2004, Section 4.10.20.3.1, "Unusual Circumstances Standard," was added to the Internal Revenue Manual.
26. A "listed transaction" is defined in Reg §1.6011-4(b)(2) as one that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction, and has identified in published guidance known as the IRS' so-called "Blacklist."
27. Announcement 2002-63, 2002-27 I.R.B. 72; I.R.M. 4.10.20.3.2(1) (7-12-04). The IRS will routinely request the tax accrual workpapers only for the listed transaction if there is only one listed transaction and it is properly disclosed.
28. Russell Carlberg, *The Perfect Storm Gathers: Recent Announcements by the IRS Coupled with the Climate of Increased Law Enforcement Call into Question Continuing Vitality of Announcement 2002-63 Regarding Tax Accrual Workpapers*, 57-6 Tax Executive 557, 558 (November-December 2005), (citing *Transcript of Tax Analysts Tax Accrual Workpaper Conference Available*, 2004 TNT 142-44 (July 23, 2004) (comments of B. John Williams, former IRS Chief Counsel)).
29. Warren Rojas, IRS, *SEC Officials Hail Reporting Gains, Downplay Disclosure Pains*, 2005 TNT 206-4 (Oct. 26, 2005) (statement by Kathy R. Petronchak, Director of Prefiling and Technical Guidance, IRS Large and Midsize Business Division).
30. Robert T. Zung, IRS *Expanding Circumstances Under Which Agency Will Seek Workpapers, Official Says*, BNA Daily Tax Report (Oct. 26, 2005).
31. Joyce E. Cutler, Korb Says Recent Government Wins Can Provide Lessons for Practitioners, BNA Daily Tax Report (June 20, 2006).
32. Alison Bennett, *Focus on Disclosure Will Continue as IRS Works to Combat Abuse, Korb Says*, BNA Daily Tax Report (Jan. 17, 2006).
33. 457 F3d 590 (6th Cir 2006).
34. Roxworthy, 457 F3d at 593 quoting *United States v Adlman (Aldman II)*, 134 F3d 1194 (2d Cir 1998).
35. *United States v Adlman (Aldman II)*, 134 F3d 1194 (2d Cir 1998). Prior to *Roxworthy, Aldman II* was the leading case regarding the application of the work-product doctrine in the audit context. In its opinion in *Aldman II*, the Second Circuit included as an example a situation in which a company's independent auditors request a memorandum prepared by the company's in-house counsel estimating the company's likelihood of success in litigation and an accompanying analysis of the company's legal strategy to assist it in estimating what to reserve for potential losses in litigation. The court found that example (along with two others) fell squarely within the zone of protection articulated by the Supreme Court in *Hickman v Taylor*, 329 US 495 (1947). See also *EEOC v Lutheran Social Services*, 186 F3d 959 (DC Cir 1999)(applying the "because of" test to work-product claims in the DC Circuit). It is also important for companies to understand the application of the work product doctrine to requests from state and local agencies, given that the IRS and state and local agencies often share tax information for compliance and enforcement purposes.
36. In this regard, *Roxworthy* probably goes further then the Second Circuit in *Adlman II* because in *Roxworthy*, the Sixth Circuit held that the documents at issue were covered by the work-product doctrine, whereas the Second Circuit in *Adlman II* found that the work-product doctrine could apply to a document prepared to inform a business decision because litigation over the business decision (specifically, over the tax treatment of the restructuring at issue) was anticipated. Following this holding, the question for the court was whether the memorandum analyzing the restructuring would have been prepared in substantially the same form regardless of whether the litigation was anticipated. Because this was not answered in the district court's findings, the Second Circuit remanded the case.
37. Citing decisions by the First and Second Circuits, the Sixth Circuit held that a document can be created for both use in the ordinary course of business (such as for penalty protection) and in anticipation of litigation without losing its work-product protection. *Adlman II*, 134 F3d 1194 at 1202 (2nd Cir 1998); *State of Maine v US Dep't of Interior*, 298 F3d 60 at 68-70 (1st Cir 2002) (adopting Adlman's allowance for dual purpose and rejecting the "primary purpose" requirement). Under this standard, a document will not be protected if it would have been prepared in substantially the same manner irrespective of the anticipated litigation. 457 F3d at 593-594. By contrast, the Tax Court remains an inhospitable jurisdiction to such work-product claims. In *Bernardo v Commissioner*, 104 TC 677 (1995), the Tax Court found that documents were not prepared "in anticipation of litigation" if they were prepared before the IRS raised the issue on audit. Thus, had Yum's work-product claim arisen in the context of Tax Court litigation, the IRS might well have secured the two KPMG memoranda.
38. *United States v Textron Inc*, 100 AFTR2d. 2007-5848 (D RI, August 28, 2007).
39. The tax practitioner–client privilege, created by IRC § 7525, confers protection on tax advice in the form of confidential communications between a taxpayer and any federally authorized tax practitioner (i.e., attorney, CPA, or enrolled

agent) but not including communication simply for the purpose of return preparation. Both attorney-client tax practitioner privileges may be waived upon the disclosure of otherwise confidential information to a third-party (including disclosures made to independent auditors), even if the third-party agrees not to disclose the information.

40. As described by the district court, the workpapers, were prepared by Textron's in-house attorneys or in-house accountants under the ultimate supervision of Textron's in-house counsel and were created after the corporate tax returns were filed, consisted of two parts. At the outset, the court noted that "[b]ecause there is no immutable definition of the term 'tax accrual workpapers,' the documents that make up a corporation's 'tax accrual workpapers' may vary from case to case." *Textron*, slip op. at 4. The first part was a spreadsheet that listed (i) each tax position considered by Textron's counsel to be arguable, (ii) estimates of litigation risks with respect to these position, and (iii) tax reserve amounts for each position. The second part comprised backup documents including the prior year spreadsheet, a draft spreadsheet, and accompanying including notes, memos, or e-mails from Textron's in-house counsel reflecting opinions regarding litigation risks. The workpaper files did not contain any "factual" materials, such as transaction documents and the like. Textron's in-house accountants created the initial workpaper package for circulation to Textron's in-house counsel.
41. While Textron permitted E&Y to examine the workpapers in conjunction with E&Y's audit, the AICPA Code of Professional Conduct prohibited E&Y from disclosing any such information without Textron's consent, and E&Y expressly agreed not to provide the information to any third party.
42. See IRC § 7525.
43. The court found that the tax accrual workpapers contained information potentially protected as work product, the attorney-client privilege, and the tax practitioner-client (IRC § 7525) privileges. Textron's disclosure of the information to its auditor, E&Y, however, waived the attorney-client privilege and the tax practictioner-client privilege. *See also United States v El Paso Co*, 682 F2d 530 (5th Cir 1982) (a summons enforcement matter involving documents similar to tax accrual workpapers, where the court held that the company's disclosure of its tax pool analysis to the company's outside auditor destroyed the confidentiality of the analysis causing a waiver of attorney-client privilege); *United States v Massachusetts Institute of Technology*, 129 F3d 681 (1st Cir 1997) (disclosure of otherwise privileged communications to government auditing agency waived privilege).
44. The *Textron* district court joined a growing list of district courts that hold that, notwithstanding the auditor's independence, the auditor is not truly an "adversary" of its audit client. *See, e.g., In re Pf zer, Inc Sec Litig*, 1993 WL 561125 (SDNY); *Merrill Lynch & Co v Allegheny Energy Inc*, 229 FRD 441 (S D NY 2004); *American S S Owners Mut Protection and Indem Assoc, Inc v Alcoa S S Co, Inc*, 2006 WL 278131 (S D NY); *Lawrence E Jaffe Pension Plan v Household Int'l, Inc*, 237 FRD 176 (ND Ill 2006); *In re JDS Uniphase Corp Sec Litig*, 2006 WL 2850049 (N D Cal 2006); *Gutter v E I DuPont de Nemours and Co*, 1998 WL 2017926 (S D Fla 1998); *Frank Betz Assoc, Inc v Jim Walter Homes, Inc*, 226 FRD 533 (D SC 2005); *In re Raytheon Sec Litig*, 218 FRD 354 (D Mass 2003). It should be noted, however, that a few courts have reached the opposite conclusion, holding that disclosure does give rise to a waiver of work product protection. *See, eg, Medinol Ltd v Boston Scientific Corp*, 214 FRD 113 (S D NY 2002); *In re Diasonics Sec Litig*, 1986 WL 53402 (N D Cal). For a comprehensive discussion on this topic see Ricardo Colon, *Caution: Disclosures of Attorney Work Product to Independent Auditors may Waive the Privilege*, 52 LOY L REV 115 (2006).
45. Thomas J Callahan, Jeffry J Erney & Gregory J Gawlik, *Tax Accrual Workpapers: IRS Efforts to Obtain Them, Corporate Strategies to Protect Them*, 55 The Tax Executive 364 (Sept-Oct 2003).
46. *Textron*, slip op at ___.
47. *Textron*, slip op at ___.
48. *Textron*, slip op at ___.
49. *Textron,* slip op at 21 (citing United States v El Paso, 682 F2d 530, 542 (5th Cir 1982)).
50. *Id*. (citing United States v Adlman, 134 F3d 1194 (2d Cir 1998)).
51. IRS Chief Counsel, Donald Korb, has already stated "We're not going to change anything as a result of this case. Nothing in the decision undermines the IRS policy of seeking tax accrual work papers when appropriate." 2007 TNT 170-1 (August 30, 2007).

ARBITRATION IN INTERNATIONAL DOUBLE TAXATION MATTERS

Reid A. Nicolosi
Michigan State University College of Law

As world economies become increasingly integrated, disputes arise regarding double taxation that may inhibit economic growth. These disputes give rise to the question of whether tax arbitration agreements between sovereign states can assist in the furtherance of cross-border transactions.

Globalization cannot be considered a new occurrence, as the act of trading goods, such as spices, has been common practice for thousands of years. The trading of indigenous materials for money or other goods has historically brought sovereign nations closer to developing a global or transnational economy. In the last twenty years, the rapid development of technology has increased the number of sovereign nations able to become part of the global economy. This development in technology, coupled with the basic tenets of economics (supply and demand), has quickly integrated globalization in all facets of the marketplace.

Tax arbitration agreements between sovereign nations promote transnational business transactions by providing an outlet for sovereign nations, as well as individuals and corporations, through which to resolve contested tax issues while actively trading. This approach furthers globalization by permitting trading to occur without hindrance. In addition, tax arbitration agreements offer assurances of certainty and the ability to minimize loss of trading time, thereby decreasing costs normally associated with taxation issues.

American and Canadian Attempts to Resolve Double Taxation Issues

The United States and Canada entered into the United States – Canada Income Tax Convention (Convention) on September 26, 1980.[1] The Convention was entered into force on August 16, 1984.[2] The benefits of this Convention are generally provided on the basis of residence.[3] Therefore, a person[4] who is recognized as a resident of the United States and has income from Canada will pay less income tax to Canada on that income and vice-versa.[5] Bilateral income tax treaties, such as the Convention, are applauded as being beneficial to both the taxpayer and the governments involved because the treaties establish clear ground rules that govern income tax matters regarding foreign trade and investment.[6]

Article 24 of the Convention details the agreement between the United States and Canada to eliminate double taxation.[7] To dispute a tax assessment that an individual believes violates the Convention, the taxpayer must carefully follow the Mutual Agreement Procedures (MAP) identified in Article 26 of the Convention.[8] Article 26(1) requires that a taxpayer notify the competent authority of his resident state to begin the resolution process:

> Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case in writing to the competent authority of the Contracting State of which he is a resident or, if he is a resident of neither Contracting State, or which he is a national.[9]

The structure of the MAP process incorporates several steps. First, the taxpayer must send a written notice to the competent authority of his resident nation, asserting that a tax assessment is not in accordance with the Convention.[10] While this begins the MAP process, this initial step by the taxpayer only brings the discrepancy to the eyes of the competent authority. The second step requires that the competent authority determine whether the taxpayer's objection to the tax assessment is valid, and then endeavor to find a resolution with the competent authority of the other contracting state.[11] Upon accepting a case brought forth by the taxpayer, the third step of the MAP process requires that the competent authorities "endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention."[12]

However, this provision in the Convention does not give a detailed description of how the competent authorities will reach a mutual agreement or how long this process will take. Consequently, the taxpayer is left in a state of helplessness because he cannot play a role in the resolution of the dispute. It is only if the competent authorities of the signatory states attempt to mutually resolve the conflict that a resolution becomes available to the taxpayer. In filing a written dispute to the Convention, a taxpayer enters a state of "taxation limbo" because the provisions in the Convention severely limit the taxpayer's involvement in the proceedings, and are exceedingly vague as to the amount of time the competent authorities have to resolve the dispute. The competent authorities of the signatory states must only "endeavor" to find a mutually-agreeable resolution to the conflict.

As the Convention reveals, provisions in tax treaties do not cover all of the technical issues that develop from international transactions. When a question develops regarding a technical issue in the interpretation of a tax treaty, a nation can amend the treaty or enter into a Memorandum of Understanding (MOU) with the other signatory nation to clarify the interpretation issue.[13] For the United States, the MOU route is faster because an "MOU is treated as not necessitating U.S. Senate 'advice and consent,'"[14] which would be needed to amend a treaty. In this manner, complex technical interpretation issues can be dealt with quickly and efficiently by the competent authorities of the signatory nations.

In fact, in 2005, the United States and Canada entered into an MOU regarding the MAP process.[15] The purpose of the MOU was to "establish an independent review process for resolving disagreements regarding the underlying facts and circumstances of a specific MAP case for further negotiations by the [Competent Authorities]."[16] However, the independent review, referred to as the Appeals Review Panel (ARP), is not available for MAP cases involving the interpretation of treaty provisions or cases in which the taxpayer failed to cooperate with either competent authority by providing relevant information.[17] Either competent authority may call for an independent review regarding the underlying facts and circumstances of a taxation dispute within six months of the commencement of the negotiation.[18] Independent review can begin at an earlier date, or can be delayed if both competent authorities mutually agree.[19]

The ARP is comprised of one appointment from each of the competent authorities' appeals organizations.[20] Each of the appointees has voting rights.[21] In addition, the competent authorities may appoint one or more non-voting members.[22] The ARP has 150 days from the referral request to conclude its work and render a decision.[23] The competent authorities must follow the decision of the ARP if both voting members of the ARP agree.[24] However, any decision reached by the ARP is not to be used as precedent for any other MAP case that may be brought before the ARP at a later date.[25]

While the United States/Canada MOU advances the MAP process by creating definite time frames thereby ensuring some type of resolution for the taxpayer by a given date, the resolution process continues to keep the taxpayer in a state of unrest. The taxpayer is still unable to actively participate in the proceeding and the independent review appears to be more of a formalized negotiation between the signatory nations rather than a viable arbitration process, in that a binding decision occurs only if the representatives of the nations find common ground in taxing the taxpayer. Therefore, unless the two voting members, who are the representatives of the nations, find a mutually-agreeable resolution to the dispute, the taxpayer will remain in the same position as he was before the process began, causing the taxpayer to pay more than his fair share of tax. Without some type of mechanism that would permit a taxpayer to take an active role in the arbitration of his tax liability, the current system creates an environment of uncertainty because it leaves taxpayers without the ability to voice their arguments and concerns in an effective manner. To continue on this path will only lead to a system that hinders the growth of a global marketplace and presents obstacles for foreign investors to engage in developing markets.

Historically, no treaty has ever granted the taxpayer access to an international arbitration process.[26] This is mainly so because, for an international arbitration process to be equitable to all three parties (the taxpayer and the two nations), the dispute resolution mechanism must be designed to solve treaty taxation conflicts in a manner that coordinates the potential conflicting interests of all parties.[27] The MAP process and the accompanying MOU were initiated as a means of resolving disputes regarding double taxation. However, the taxpayer who is actually affected by the conflict is not permitted to argue on his own behalf, although voting members of the ARP may request supplemental information from any party.[28]

In addition, the commencement of the MAP process is left solely to the discretion of the competent authorities of the contracting nations. Furthermore, the competent authorities are not obligated to reach a solution. Instead, representatives of the competent authorities are required to negotiate a mutually-agreeable resolution without the participation of the taxpayer. This process severely decreases and limits the amount of certainty a foreign investor has in moving capital from stagnant domestic investments into emerging foreign markets. Without the ability of the taxpayer to actively participate in the dispute resolution process, the MAP process continues to disappoint taxpayers as the foundational mechanism for obtaining relief from double taxation.

FUTURE DEVELOPMENTS IN INTERNATIONAL TAX ARBITRATION

Many non-governmental organizations have proposed revisions to the MAP process that would enable the individual taxpayer to participate directly in the dispute resolution process.

OECD INITIATIVE

The Organization for Economic Co-Operation and Development (OECD) represents a group of 30 country members[29] that share similar commitments to democratic government and stable market economies.[30] The OECD plays a prominent role in advancing good government and international trade by producing internationally agreed-upon instruments and recommendations that establish guidelines for conducting trade in the emerging global economy.[31]

To assist in eliminating double taxation, the OECD has published its own Model Tax Convention since 1992.[32] The OECD's Model Tax Convention acts as a standard from which countries can build their own bilateral tax treaties. Article 25 of the OECD Model Tax Convention deals with the MAP process and acts as a guide for countries developing their own specific MAP.[33] The OECD continually works to update its Model Tax Convention to discover better and more efficient methods of eliminating barriers to trade caused by double taxation.

The latest update to the OECD's Model Tax Convention was adopted by the OECD's Committee on Fiscal Affairs in January of 2007, and mainly deals with the use of arbitration to resolve disputes stemming from the MAP process. The OECD has observed deficiencies in the MAP process due to its failure to provide complete resolution for disputes arising out of double taxation issues. These deficiencies can lead to decreases in the number of cross-border transactions. As the OECD has recognized:

> The MAP mechanism has worked well in the past, but in recent years both the number of cross-border disputes and the complexity of the cases involved have risen and unresolved issues have become more common. Failure to resolve cases may occur for various reasons, including disagreements on what constitutes a permanent establishment, on the interpretation of a treaty provision and on the valuation of intangibles or services. Failure to resolve a case usually leads to double taxation, which can be a major impediment to cross-border activity.[34]

The purpose of the OECD update is to advance arbitration as a means of resolving double taxation disputes under the MAP process. The addition of an arbitration mechanism to the MAP process should not be viewed as an alternate or additional recourse to the MAP process, but as an extension of the MAP process.[35] Arbitration would become an option only when the competent authorities cannot reach agreement on a particular issue that prevents total resolution of the dispute.[36] An arbitration mechanism permits nations to maintain their notion of national sovereignty, while allowing the taxpayer a mechanism for obtaining definite resolution. This can be achieved because "the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process."[37]

The proposed arbitration procedure requires a definite time frame for many aspects of the arbitration proceeding. Each of the competent authorities involved in the MAP process has three months to appoint one arbitrator.[38] Within two months after appointment, the appointed arbitrators will jointly select a third arbitrator to act as the chairperson during arbitration.[39] If either competent authority fails to appoint an arbitrator or the chairperson is not chosen within the required time period, the proposed arbitration procedure calls for the appointments to be made by the Director of the OECD Centre for Tax Policy and Admission.[40] The OECD's proposed arbitration process increases the certainty of cross-border transactions by providing these definite time frames.

In addition, the proposed arbitration procedure gives the taxpayer an active voice in the resolution of the dispute. Paragraph 11 of the sample arbitration agreement, provided in the February 2007 OECD update, provides "that the person requesting arbitration, either directly or through his representatives, is entitled to present a written submission to the arbitrators and, if the arbitrators agree, to make an oral presentation during a meeting of the arbitrators."[41] If countries included this section in their bilateral tax treaties, it would be the first time a taxpayer would have the ability to actively and directly be involved in the resolution of his own double taxation dispute.

The ICC Initiative

The International Chamber of Commerce (ICC) is another non-governmental organization that promotes direct taxpayer participation in resolving double taxation disputes. The ICC was established in 1919 with a principal goal "to serve world business by promoting trade and investment, open markets for goods and services, and the free flow of capital."[42] The ICC was instrumental in the creation of the International Court of Arbitration, and continually acts as a consultant to the United Nations as well as governmental organizations. Member parties to the ICC represent both large and small companies encompassing every aspect of the marketplace, including all industry leaders. To assist in the furtherance and advancement of free trade among markets, the ICC established the International Court of Arbitration in 1923. Since the Court's inception, over 13,000 cases involving parties from over 170 nations have been successfully resolved.[43]

In addition, the ICC's taxation group issues policy statements that speak for international businesses to create an economic environment that fosters cross-border transactions by eliminating certain taxation issues. The ICC has actively promoted arbitration as a means of dispute resolution for double taxation matters:

> Binding and compulsory arbitration can eliminate or alleviate many of these concerns. Arbitration always reaches a conclusion, provides for impartial determinations with proper taxpayer participation, and applies law rather than expediency. While arbitration may also present delays, the process is orderly, predictable and transparent.[44]

The ICC's purpose is to encourage governments to evolve the dispute resolution process and develop the necessary mechanisms to resolve disputes that have developed from globalization. As world economies increasingly become intertwined, governments must adapt to meet the needs of increased cross-border transactions and permit individuals and corporations to cultivate the benefits of emerging markets. Without the ability to directly represent his interest in a double taxation dispute, the taxpayer is left in an indeterminate state of not knowing when or if resolution will occur. This process increases the costs of conducting cross-border transactions and leads to the reduction of efficient capital investment by increasing market uncertainty. Individuals and corporations are more apt to refrain from placing money in an emerging market when tax liabilities on income are uncertain and there is no active mechanism to challenge a discrepancy.

Conclusion

To prevent disturbances to the global economy, the current MAP process must be altered. Both the United States and Canada have taken notice of the deficiencies in the current MAP process and the deleterious effect it has on international transactions and foreign investment. At the 2006 International Taxation Conference, Hal

Hicks, a United States Treasury Department official, spoke to the importance of revolutionizing the current MAP process to include an element of arbitration:

> I will say that the US strongly supports the planned improvements in the MAP process and the use of arbitration. . . . An improved MAP process is critical to making sure that taxpayers don't inappropriately bear the costs of disputes between countries. And, arbitration will be a key tool in minimizing double taxation.[45]

The same sentiments are echoed in Canada. The Ottawa Citizen recently printed an article that noted that Canadian start-ups are at a large disadvantage because the current tax regime discourages cross-border investment:

> Canada's cross-border tax policies discourage U.S. investments in Canadian start-ups, which on the average only attract one-third of the capital U.S. competitors get . . . . As a result, many Canadian start-ups have "to be sold early in their life cycles and long before they attain market leadership, frequently to large U.S. companies, and often at low prices…."[46]

The article states that Canadian business ventures are suffering from the lack of American foreign investment. This lack of foreign investment stems from an absence of investor confidence in a marketplace that forbids active investor participation in resolving taxation disputes. A mandatory arbitration mechanism grants individuals a voice, and promotes efficiency in cross-border trading and investment by allowing taxpayers to actively participate in the resolution process. Like the ability investors have under NAFTA Chapter 11 to unilaterally enter into arbitration to resolve disputes stemming from domestic disturbances to foreign investments, the MAP process must be altered to permit taxpayers the ability to obtain resolution as quickly as possible. Money formerly lost in disputing taxation issues can be redistributed into other profitable ventures.

The introduction and use of a mandatory arbitration mechanism grants the foreign investor an active voice to the dispute and greatly increases investor confidence in foreign markets. An increase in investor certainty in conducting cross-border transactions will lead to an increase in business as more participants enter foreign markets. Decreasing costs associated with the current MAP process, such as indefinite timeframes for resolution or the uncertainty of even actually obtaining resolution, and increasing investor confidence in the resolution process will ultimately lead to an increase in individuals and corporations willing to conduct cross-border transactions. In addition, an increase in investor confidence will promote the efficient use of foreign capital as it moves from stagnant domestic investments into emerging foreign markets, causing an increase of jobs and the promotion of economic stability.

Both the United States and Canada have become aware of the problems the current MAP process creates by not providing taxpayers with an efficient and definite resolution process for disputes arising out of double taxation. Mandatory arbitration provides all three parties to the dispute, the taxpayer and the two nations, the ability to equitably find resolution. Under an arbitration mechanism, the taxpayer will be able to actively participate in the resolution process. This is a giant step forward in solving taxation disputes and increasing confidence in the global economy. In addition, arbitration can be viewed as simply an extension of the current MAP process. Therefore, a nation's notion of sovereignty is not infringed upon because resolution must still be agreed upon by the nations themselves. By implementing mandatory arbitration agreements into the MAP process, nations will remove a hindrance that has plagued cross-border transactions and promote the advancement of a beneficial global economy.

Reid A. Nicolosi is a student at the Michigan State University College of Law and will be graduating December 2007, In addition to an American law degree, Reid has studied Canadian law at the University of Ottawa, Faculty of Common Law and will be conferred a Canadian Law Degree (LLB) in May of 2008. Reid worked in the Michigan State College of Law Low Income Taxpayer Clinic over the summer and plans on continuing his education with a LLM in taxation law.

ENDNOTES

1. United States–Canada Income Tax Convention, 26 September 1980 (entered into force 16 August 1984) *available at* http://www.irs.gov/pub/irs-trty/canada.pdf.
2. *Id.* The difference in the dates that the Convention was signed and entered into force reflects the time needed for the ratification procedures of the Contracting States.
3. U.S. Dep't of the Treas., Internal Revenue Service, Publ'n No. 597, Information on the United States – Canada Income Tax Treaty (February 2006).
4. Publication 597 does not define the term "person" and an argument can be made that the term "person" includes both an individual as well as a corporation because the benefits of the Convention are based on a taxpayer's residence.
5. *Id.*
6. William P. Streng, "U.S. Tax Treaties: Trends, Issues, & Policies in 2006 and Beyond", 59 SMU L. Rev. 853 at 856.
7. United States –Canada Income Tax Convention, *supra* note 1, at Article XXIV, *available at* http://www.irs.gov/pub/irs-trty/canada.pdf.
8. *Id*. at Article XXVI.
9. *Id*. at Article XXVI(1).
10. *Id*.
11. *Id*. at Article XXVI(2).
12. *Id*. at Article XXVI(3).
13. Streng, *supra* note 6, at 856.
14. *Id*.
15. Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding Factual Disagreements Under the Mutual Agreement Procedure. (December 8, 2005) available at http://www.cra-arc.gc.ca/tax/nonresidents/comp/MOU_Appeals.pdf.
16. *Id*. at Section II.1. The competent authorities for the United States and Canada are the Internal Revenue Service (IRS)

and the Canadian Revenue Agency (CRA) respectively. See, e.g., note 15.

17. *Id*. Section II.2.
18. *Id*. Section III.1.
19. *Id*. Section III.1.
20. *Id*. Section III.4. The MOU defines Appeals Organization as "either the Appeals Branch of the Canada Revenue Agency (CRA) or Appeals of the Internal Revenue Service (IRS), or both." See e.g., note 15 at Section I.
21. *Id*.
22. *Id*.
23. *Id*. Section III.6.
24. *Id*. Section III.7.
25. *Id*. Section III.8.
26. Mario Züger, Arbitration under Tax Treaties: Improving Legal Protection in International Tax Law, in IBFD Academic Council's Doctoral Series, (vol. 5, 2001) at 10.
27. *Id*. at 6-7.
28. *Supra* note 15 at Section III.5.
29. The United States of America became a member on April 12, 1961; Canada became a member on April 10, 1961.
30. Organization for the Economic Co-Operation and Development (OECD), *available at*, http://www.oecd.org/about/0,2337,en_2649_201185_1_1_1_1_1,00.html.
31. *Id.*
32. Organization for Economic Co-Operation and Development, OECD Model Tax Convention on Income and on Capital, *available at* http://www.oecd.org/document/37/0,2340,en_2649_33747_1913957_1_1_1_1,00.html.
33. Organization for Economic Co-Operation and Development (OECD) "Improving the Resolution of Tax Treaty Disputes", (February 2007), *available at* http://www.oecd.org/dataoecd/17/59/38055311.pdf.
34. Organization for Economic Co-Operation and Development (OECD) "Arbitration to be an option in cross-border disputes, OECD countries agrees", (February 7, 2007), *available at* http://www.oecd.org/document/40/0,2340,en_2649_37989739_38057000_1_1_1_1,00.html.
35 Organization for Economic Co-Operation and Development, *supra* note 33, at 7.
36. *Id*.
37. *Id*.
38. Organization for Economic Co-Operation and Development, *supra* note 34 at 19.
39. *Id*.
40. *Id*.
41. *Id*. at 22.
42. International Chamber of Commerce, *available at* http://www.iccwbo.org/id93/index.html.
43. International Court of Arbitration, *available at* http://www.iccwbo.org/court/english/intro_court/introduction.asp.
44. International Chamber of Commerce, Policy Statement (June 13, 2000) *available at* http://www.iccwbo.org/policy/taxation/id501/index.html?cookies=no.
45. Hal Hicks, Lunch Speech detailing the OECD role and function from the U.S. Treasury standpoint, (5 June 2006), *available at* http://www.oecd.org/document/15/0,2340,en_33873108_33873886_36938255_1_1_1_1,00.html.
46. Kristen Goff, "Tax Regime discourages U.S. venture capital, study says", The Ottawa Citizen 14 February 2007 D1.