

Anticipating the Audit Letter: Planning and Defending Against IRS Attacks on Entity Planning

**ACTEC
2010
Fall Meeting
October 15, 2010**

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BEGIN WITH THE END IN MIND



PHOTO ILLUSTRATION/THINKSTOCK

TALES FROM THE FRONT

Anecdote

INVENTORY OF IRS ATTACKS

Matrix

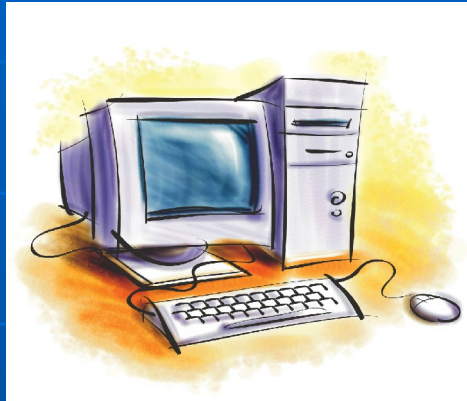
IRS Entity Attack List September 2010

Issues arise: "P" Planning Phase; "A" Audit and/or Litigation	Retained life interest - 2036(a)(1), 2038	Retained control - 2036(a)(2)	Indirect gift of underlying assets	Step transaction	Present interest gift - 2503(b)	Valuation 2703(a)(2) and 2704(b)	Valuation - accuracy penalties	Audit request for materials	Marital deduction "mismatch"	Transfer or relinquishment w/in 3 yrs of death - 2035(d)	Sham transaction - 2043	Respecting entity							
I. Decision to Establish an Entity																			
A. Initial Contacts and Communication																			
1. Oral communications	A	A	A	A				P					A	A					
2. Written communications	A	A	A	A				P					A	A					
3. Explanatory materials	A	A	A	A				P					A	A					
4. Qualification of client								P											
5. Qualification of assets								P											
6. Is an entity appropriate?								P											
7. Sufficient assets outside of entity?	P	P						P											
8. Preservation of records and communications	A	A						P											
9. Discussion of risks under audit	P	P	P	P	P	P	P	P	P	P	P	P	P	P					
10. Strength of Advisor Team						P	P	P	P				A	A					
II. Design of the Entity								P											
A. Purpose	P	P		P	P			P											
B. Focus of Discussion	P	P		P	P	P	P	P											
D. Cash-flow plan	P	P			P			P					P	P					
E. Control plan	P	A			A			P					P	P					
F. Data gathering and maintenance	A			A	A		A	A	P										
III. Establishment - Formation/Organization								P											
A. Establishing under state law	A	A	A	A			A	P					A	A					
B. Organization	A	A	A	A	A	A	A	A	P	P			P						
C. Funding	A	A	A	A	A	A	A	A	P	A	A		A	A					
D. Capital accounts	A	A	A	A	A	A	A	A	P				A	A					
E. Communications with third parties/Representation	A	A	A	A	A	A	A	A	P				A	A					

	Retained life interest - 2036(a)(1), 2038	Retained control - 2036(a)(2)	Indirect gift of underlying assets	Step transaction	Present interest gift	Valuation 2703(a)(2) and 2704(b)	Valuation - extent of discounts	Valuation - accuracy penalties	Audit request for materials	Marital deduction	Transfer or relinquishment	Partial "double inclusion" - 2043	Sham transaction w/in 3 yrs of death - 2035(d)	Respecting entity
Issues arise: "P" Planning Phase; "A" Audit and/or Litigation														
IV. Operations & Maintenance	A	A	A	A	A	A	A	A	P			A	A	
A. Bookkeeping and accounting	A	A	A	A	A	A	A	A	P	A		A	A	
B. Tax reporting	A	A	A	A	A	A	A	A	P	A	A	A	A	
C. Distributions	A	A	A	A	A	A	A	A	P			A	A	
D. Dealings with partners or members	A	A	A	A	A	A	A	A	P	A		A	A	
E. Entity makes significant changes	A	A		A	A		A		P			A	A	
V. Wealth Transfer	A	A	A	A	A	A	A	A	P	A	A	A	A	
A. Lifetime gifts	A	A	A	A	A	A	A	A	P	A	A	A	A	
1. Initial gifts	P	P	A	A	A	A	A	A	P	P	P	P	P	
2. Ongoing gifts	P	P	A	A	A	A	A	A	P	A	A	A	A	
3. Accounting and reporting	A	A	A	A	A	A	A	A	P	A	A	A	A	
4. Adherence to Agreement & Documentation	A	A	A	A	A	A	A	A	P	A	A	A	A	
5. Valuations and appraisals						A	A	A	P	A	A			
6. Anticipating audits	P	P	P	P	P	P	P	P	P	P	P	P	P	
B. Sale	P	P	A	A	A	A	A	A	P	P	A	P	A	A
C. Redemption	P	P	A	A	A	A	A	A	P	P	A	P	P	A
D. Death	A	A				A	A	A	P	A	A	A	A	A
1. Payment of Est Tax & Admin Expense by Pp	A	A							P					A
E. Reporting	A	A	A	A	A	A	A	A	P	A	A	A	A	A
VI. Audit	A	A	A	A	A	A	A	A	A	A	A	A	A	A
A. Income									A				A	A
B. Gift			A	A	A	A	A	A	A	A				
C. Death	A	A	A	A	A	A	A	A	A	A	A	A	A	A
D. Litigation Counsel	A	A	A	A	A	A	A	A	A	A	A	A	A	A
E. Documents	A	A	A	A	A	A	A	A	A	A	A	A	A	A
F. Burden of Proof	A	A	A	A	A	A	A	A	A	A	A	A	A	A
G. Penalties						A	A	A	A					

Decision to Establish an Entity

Oral & Written Communications



INITIAL CONTACTS AND COMMUNICATION

- Discovery – written & oral communications
- Privilege – waive or not?

Decision to establish an entity

PURPOSE

A legitimate and significant non-tax purpose for establishing the entity can cure a lot of ills!

PURPOSE - HELPFUL

- Creditor protection
- Divorce protection
- Litigation protection and management efficiency
- Hold legacy assets and buy/hold philosophy
- Avoid “standard” nontax motives without application

PURPOSE - HARMFUL

- **Bad facts as to purpose**
 - **Reduce estate tax**
 - **Testamentary planning**

COMMUNICATIONS & PURPOSE

- Focus of discussions – tax savings, estate planning, testamentary transfers (bad) or legitimate and significant nontax business or investment reasons (good)?

PURPOSE – PROACTIVE PLANNING

- Document non-tax reasons for forming entity
- Subject to discovery
- Favorable facts

Design of the Entity – (QUALIFICATION STAGE)

- Qualification of client and partners
 - Avoid retention of income I.R.C. § 2036(a)(1)
 - Avoid retention of control attacks (2036(a)(2))

Design of the Entity – (QUALIFICATION – CLIENT/PARTNERS)

- Financial independence from Entity?
- Health of client
- Age of client
- Capacity of the client
- Willingness to abide by terms and conditions – client and partners

Qualification of the Assets

- In support of legitimate non-tax purpose
 - I.R.C. § 2036(a) bona fide sale exception
 - Modern portfolio theory
 - Assets that can only be owned by those satisfying “accredited investor” or “qualified investor” rule
 - Assets requiring active professional management
 - Lowering investment costs by pooling assets
 - Exclude the personal residence and other personal assets

Risk analysis

- Costs and other considerations
- Alternatives – GRATs, IDGTs, private annuities, CLATs, ILITs, etc

Cash-flow Plan

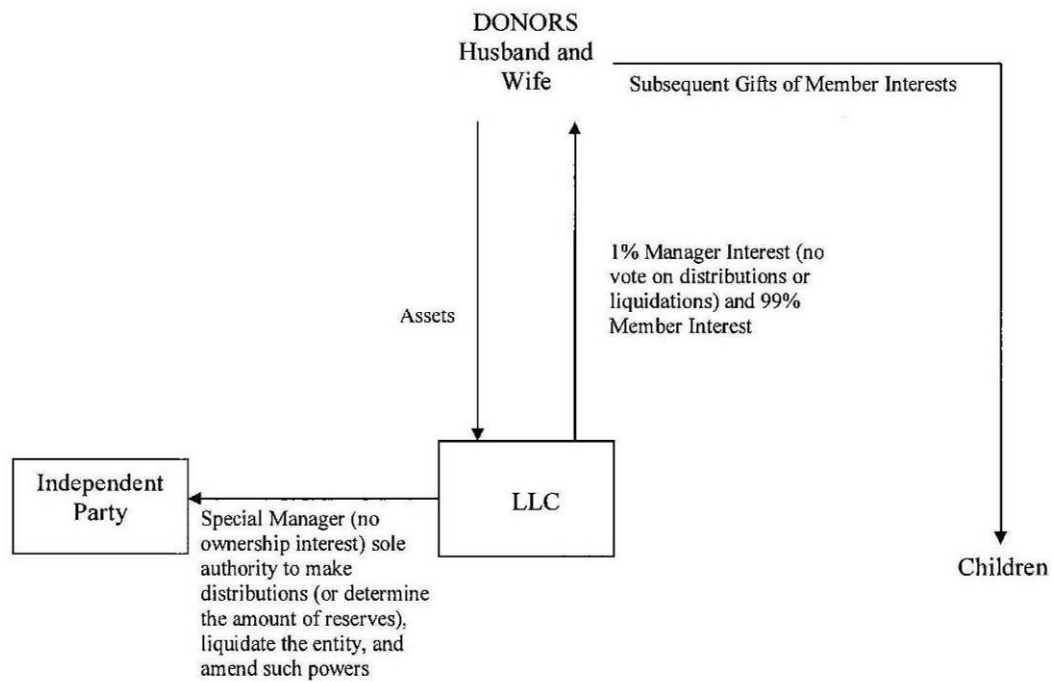
- **I.R.C. § 2036(a)(1) avoidance**
 - **Involve accountant and financial planner - calculate transferor's financial needs**
 - **Sufficient assets outside of entity to maintain lifestyle?**
 - **Preservation of Records and Materials**
 - **Discussion of risks under audit**
 - **Strength of advisor team – Appraisers, accountants, attorneys, financial advisors**

Control plan

- Avoidance of I.R.C. § 2036(a)(2)
- Limit distribution powers - enforceable standard subject to court review and supervision
- Formula distributions
- Special manager
- Trusts with independent trustees
- Avoid retention of powers by donor partner and for other partners whose actions may be attributed to donor
- Non-contributing partner serving as manager
- Bifurcate powers of general partner

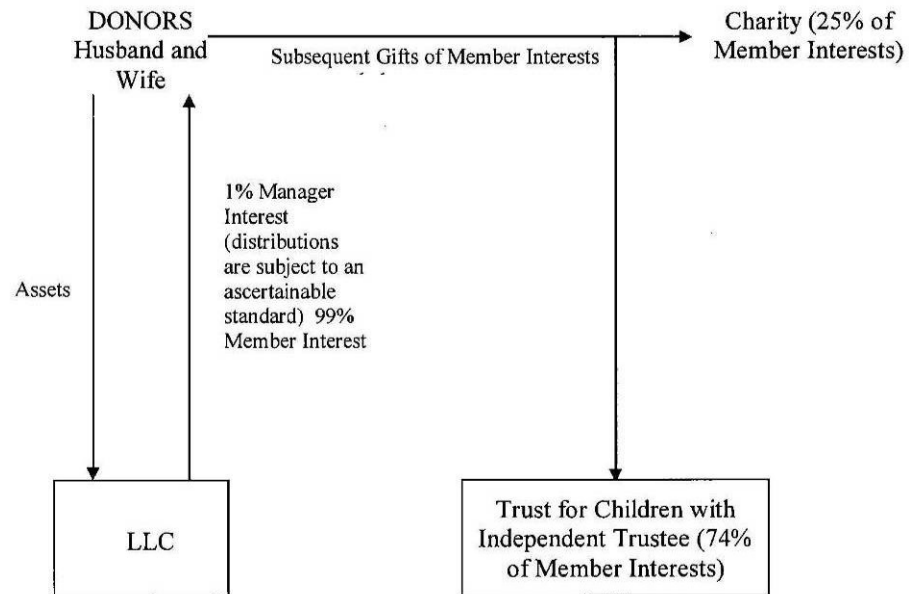
NEW FAMILY ENTITY WITH SPECIAL MANAGER

Section 2036(a)(2) Does Not Apply



NEW FAMILY ENTITY WITH TRANSFERS TO CHARITIES AND TRUST FOR CHILDREN

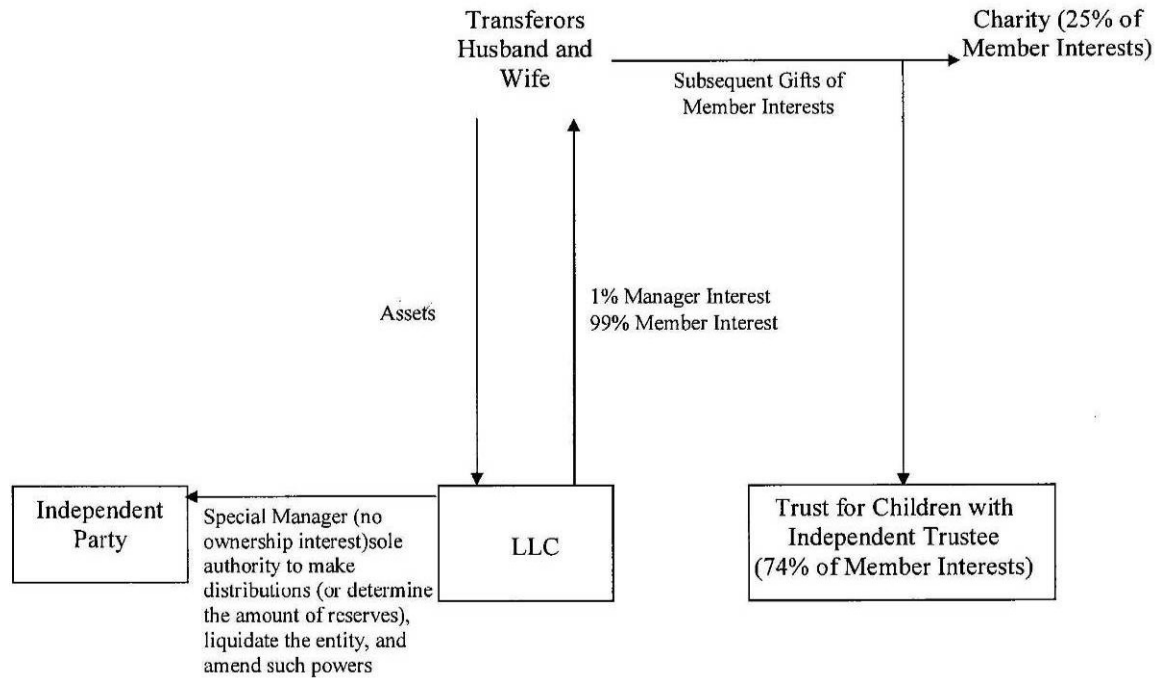
Section 2036(a)(2) Arguably Does Not Apply*



* Independent ownership and oversight adds accountability to Donor's fiduciary duty.

**NEW FAMILY ENTITY WITH SPECIAL MANAGER AND
TRANSFERS TO CHARITIES AND TRUST FOR CHILDREN**

Section 2036(a)(2) Does Not Apply*



* Ownership of minority interests and oversight by non-family members; Independent Trustee has discretionary authority to make distributions to Children.

Establishment – Documentation – Formation, Organization and Implementation Stage

- *First things first!*
- Establish under state law
- Organization - Prepare operating or entity agreement
- Capital accounts
- Entity bank accounts

Establishment – Documentation – Formation, Organization and Implementation Stage

- **Funding:**
 - **Contributions and credit to contributing partner's capital account**
 - **Record deeds and title transfers to entity**
 - **Children funding entity with their own assets?**
 - **Retitle investment accounts in trust to entity**
 - **Defined valuation clause stated in dollars relative to marital deduction or disclaimers with excess passing to charity? IRS disapproves**

Establishment – Documentation – Formation, Organization and Implementation Stage

- Communicating with Third Parties
 - Accountants
 - Appraisers - conversant with the impact of IRS attacks and court cases
 - Insurance advisors – follow through on policies
 - Investment managers – title accounts
 - Attorneys for other partners - Independent representation of other partners and negotiation
 - Independent trustees involved for children/grandchildren's trusts?

Defer Gifting Strategy

- **Observe proper sequencing and timing**
- **Indirect gifts I.R.C. § 2511(a)**
- **Step transaction theory**

Defer Gifting Strategy

1. **Proper formation under state law**
2. **Contributions by all partners in exchange for prorata interests in entity**
3. **Credits to all partners' capital accounts**
4. **Wait before gifting taking into account an appropriate time for exposure of the issued interests to a real economic risk**
5. **Time period between funding, crediting contributing partner's capital account and gifts**
6. **Delay discussion and documentation of gifts**
7. **Defer substantive discussions regarding amounts of gifts, drafting trusts of as recipients of gifts and actual transfers of entity interests**

Operation of the Entity (documentation, monitor and maintenance stage)

- **“Respecting the entity” – Meetings?**
 - **Actual meetings**
 - **Attorneys, accountants and investment advisor participation?**
 - **Maintain minutes of meetings**

Operation of the Entity - Distributions

- **Avoiding I.R.C. § 2036(a)(1) and (2)**
 - **State law with fiduciary standards?**
 - **Standards enforceable in court?**
 - **Proportionate or disproportionate?**
 - **Accounting and reporting**
 - **Maintenance of separate books and records**
 - **Banking – maintenance of separate bank accounts for the entity and for the transferor**
 - **Tax Reporting – timely and regular**

Wealth Transfer – Lifetime Gifts

- Avoidance of indirect gift - I.R.C. § 2511(a)
 - Initial gifts
 - Timing. Deferred until the entity has been fully formed and organized
 - Time between completion of formation and organization and the actual gifting sufficient to subject interests to “real economic risk of change in value” in market? Rule of thumb of 6 days to 2 months?
 - No express statutory or regulatory support and only limited judicial support in *Holman* as dicta

Wealth Transfer – Lifetime Gifts

- **Ongoing gifts – proper credits and adjustments to capital accounts, distributions reflect changes in ownership and documentation of the same**

Wealth Transfer – Indirect Gift

- **Lifetime gifts: Indirect gift of underlying assets on formation of entity or for later gifts - Reg. §25.2511-1(h)(1)**
 - **Indirect gift of underlying assets defeats justification for discounts related to minority interest and lack of marketability attached to gifts of entity interests**
 - **Order of transfer of assets to the entity – before, at the same time or after the transfer of interests in the entity?**

Wealth Transfer – Step Transaction

- **Lifetime gifts: Step transaction (A judicially recognized concept)**
- **Three versions of the step transaction doctrine – the Tax Court has not adopted a particular version:**
 - **Binding commitment test**
 - **End result test**
 - **Interdependence test**

Wealth Transfer – Step Transaction

- **“Independent Significance” to the funding of the partnership and a subsequent gift of partnership interests?**
- **Passage of time not disregarded if interest subject to “economic risk”. Volatility of assets between time of contribution and gift of interest in entity**
 - **Avoidance of step transaction attack. Defer gifts until sufficient time for exposure to real economic risk of a change in value**
 - **Nature of assets and attendant volatility**
 - **Publicly traded stock - less time**
 - **Low volatility assets: Municipal bonds, Treasuries, preferred stock and real estate - more time**

Wealth Transfer – Lifetime Gifts

- **Lifetime gifts: Present interest -annual gift tax exclusion**
- **Substantial present economic benefit to donee members of entity**
- **Use or possession of transferred property or ability to put interest and liquidate interest**

Wealth Transfer - Death

- I.R.C. § 2036(a) – Fit into exception?
- I.R.C. § 2036(a)(1) – Evidence of Implied Agreement to retain income or benefit of property?
- Payment of estate tax and administration expenses as implied agreement
- Alternatives
 - Loans
 - Sale of interest to other partners, third party loans, partial redemptions, etc.)

Wealth Transfer - Death

- I.R.C. § 2036(a)(2) – control attacks
- See III. E of Outline

Wealth Transfer - Death

- **I.R.C. § 2036(a) – Bona fide sale for adequate and full consideration exception**
 - **Legitimate and significant non-tax purpose**
- **I.R.C. § 2038(a) and exception (see discussion above in I. C. 1. c.)**

Wealth Transfer - Death

- **Transfer or relinquishment of interest or power within 3 years of death I.R.C. § 2035(a)**

Wealth Transfer - Death

- “Double inclusion” of value – I.R.C. §§ 2043, 2036 and 2033

Wealth Transfer - Death

- Marital deduction “mismatch”

Valuation – Gift or Death

- **Disregarded restrictions under I.R.C. § 2703(a)(2)**
- **Exception - I.R.C. § 2703(b)**
- **Exception suggests active business or active investment management is required**

Valuation – Gift or Death

- *Holman* - Departure from “willing buyer/willing seller” to “rational economic actor”
- Decreased valuation discounts

Valuation

- **Lapsing rights and restrictions**
I.R.C. § 2704(a)
- **Exception: I.R.C. § 2704(b)**

Valuation - Compliance

- **Accounting and Reporting**
- **Accuracy related penalties I.R.C. § 6662**

Audit



Audit



- **IRS Appeals Coordinated Issue Settlement Guidelines**
- **Procedure**
- **Litigation counsel**
- **Summonses**
- **Burden of proof**
- **Penalties**