GETTING YOUR CLIENT A BETTER RESULT WHEN THE IRS ESTATE TAX EXAMINER PROPOSES A DEFICIENCY

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This outline focuses on resolving estate and gift tax audit disputes with IRS, both through the administrative process and through litigation. The emphasis is on dealings with the IRS at the post-audit administrative levels because, as a practical matter, most disputes are resolved without litigation. References are to *estate* taxes but the procedures are generally the same for *gift* tax audit disputes.

Putting the entire process in perspective, it is estimated that more than 90% of all estate tax audits are resolved at the Examination level and that more than 90% of the remaining 10% of audits are resolved at the Appeals Office level. As a result, less than 1% of the audits are resolved through litigation.

I. TAKING ON THE IRS CAN PRODUCE FAVORABLE RESULTS

A. THE PERCEPTION

There is a general perception among taxpayers that it is not worthwhile to fight because the IRS is the IRS and it gets what it wants. Part of the perception is the fear that if the taxpayer fights, the taxpayer will be targeted for future audits. Of course, retaliation generally is not as significant a concern when a one-time estate tax audit is involved as in an income tax audit.

B. THE REALITY_AT APPEALS OFFICE LEVEL

Statistics regarding the IRS Appeals Office, one level above the estate tax examiner, are favorable to taxpayers. Although the IRS no longer publishes the statistics it once did, they showed that the IRS in Appeals had a **recovery rate of less than one-third** of the amount originally determined to be due and owing by the IRS auditing agent. These statistics included all types of taxes, not just estate and gift. They may be somewhat skewed because they included large cases which, though few in number, had a significant impact on the statistics on account of the large amounts involved.

C. THE REALITY_WHEN LITIGATION IS INVOLVED

Similar statistics have shown that the IRS had an **average recovery rate of about 20%** of the amount that the auditing agent initially determined to be due when the contested issues were eventually resolved in Tax Court.

D. REVIEW IS WARRANTED

Because the facts of each case are unique, it is impossible to generalize as to what will happen if a particular matter is contested with the IRS. An estate cannot assume that it will pay less by appealing. Nevertheless, the statistics, despite being several years out of date, cannot be dismissed. Even if it is assumed that taxpayers today are not faring as well in Appeals as in the past, the experience of practitioners suggests that all significant IRS audit determinations, including estate tax determinations, be reviewed to determine whether a better result can be obtained.

II. BACKGROUND: THE SELECTION AND AUDIT OF THE RETURN

A. SELECTION OF RETURNS FOR AUDIT

1. Service Center. The Ogden Service Center processes all estate tax returns of Washington residents. The Service Center reviews the returns to ensure that required information is included and reviews the tax computation for accuracy.

2. Seattle Office. In the Seattle office, which will be a part of the Small Business/Self –Employed Division of the IRS, estate tax examiners review returns in Ogden for audit potential. Four times a year, two or three of the examiners go to Ogden to review the returns.

3. Chance of Audit _Washington. In recent years, perhaps 2,000 to 2,500 returns were filed on behalf of Washington State decedents each year. The Service selected for audit about one out of every five of these returns, but because of limited resources, audited perhaps half. Today, audit rates are dropping as more estate tax returns are filed, perhaps partly due to buoyant stock portfolio and real estate values.

4. Estate Tax Returns Filed. For the entire Pacific-Northwest District (four-state area), 3,903 estate tax returns and 9,557 gift tax returns were filed in fiscal 1997.

5. Audit Statistics _Washington. For 1995, the IRS in Washington State completed the audit of 161 estate tax returns and 27 gift tax returns. The IRS used to audit more returns but today the returns are more complicated and IRS resources are limited.

6. Gift Tax Returns. Twice a year examiners go to Ogden to

review gift tax returns for their audit potential.

7. National Audit Statistics (Estate Tax Returns). For 1997, the chance of audit was 6.83% when the gross estate was less than $1 million; 18.88% when between $1 million and $5 million; and 47.43% when over $5 million. For all estate tax returns filed, no matter the value of the gross estate, the overall audit percentage was 12.90%. The "no change" rate was approximately 1 in 10. The average tax and penalty determined per return was $122,775 although for estates over $5 million the average was $680,054.

8. National Audit Statistics (Gift Tax Returns). The IRS audited only 0.90% of gift tax returns. There was a 20% "no change" rate. The average assessment of tax and penalty was $129,708.

B. AUDIT OF RETURNS

1. Examiners. There are currently fifteen estate tax attorneys (also referred to as examiners) in the estate and gift tax group which covers Washington, Oregon, Hawaii, Alaska and Idaho. Two are located in Seattle, one in Spokane, two in Bellevue, two in Hawaii, one in Alaska, two in Idaho, and five in Oregon.

2. Broad Authority. Examiners of the IRS are given the authority to examine books, records and witnesses. The usual goal is to ascertain the correctness of the return. Congress authorized IRS personnel to issue a summons for documents and witnesses in order to determine such correctness. The summons power is very broad.

C. AUDIT ISSUES

The IRS publishes a handbook, the "Examination Technique Handbook for Estate Tax Examiners," for use by its estate and gift tax attorneys. The handbook provides guidance to the attorney on methods and techniques to be followed in examining various issues. Among the issues included in the handbook are the following:

Valuation of Real Property
Stocks and Bonds
Mortgages, Notes, and Cash
Life Insurance

Jointly Owned Property

Currently the IRS is looking, in particular, for returns with family limited partnership and residence trust issues.

D. TIME LIMITATIONS

1. Policy. It is the policy of the IRS to complete the examination of an estate tax return within 18 months after the filing of the return.

2. No extension. In the case of an estate tax return, the three-year statute of limitations cannot be extended by agreement. IRC § 6501(c)(4). There are exceptions to the three-year rule.

3. False or Fraudulent Return. There is no statute of limitations in the case of a false or fraudulent return with the intent to evade tax. IRC § 6501(c)(1).

4. Substantial Omission. There is a six-year statute of limitations if the estate tax return omits items representing more than 25% of the gross estate stated on the return. IRC § 6501(e)(2).

III. OPTIONS AFTER THE ESTATE TAX EXAMINER HAS PROPOSED A DEFICIENCY/ PROS AND CONS OF EACH

There are numerous options for the estate in pursuing an appeal, once the estate tax examiner has proposed a deficiency: 1) estate tax examiner; 2) estate tax examiner's supervisor (group manager); 3) Appeals Office; 4) mediation/arbitration in Appeals; and 5) Court (either Tax Court, federal district court or U.S. Court of Federal Claims).

A. ESTATE TAX EXAMINER

1. Authority to Settle.

Technically, the IRS examiner has **no authority** to settle a case based on the hazards of litigation. The authority to settle cases resides in the Appeals Office of the IRS. Nevertheless, it is estimated that **more than 90% of estate tax audits are resolved at the Exam level**. This is at least partly attributable to the majority of the disputes involving valuation issues. As there is no absolute right or wrong, valuation disputes lend themselves to resolution. Also, as a

practical matter, examiners have great latitude in making factual determinations and deciding what issues will be raised but little latitude in interpreting the law.

2. Pros and Cons of Trying to Resolve the Issues with the Examiner.

a) Lack of Objectivity. After spending up to one year or more doing an audit, the examiner may have a difficult time appreciating the opposing point of view.

b) Avoids Expense. Resolving an issue with the estate tax examiner eliminates the expense of an appeal.

c) Examiner Accustomed to Resolving. An estate tax examiner is accustomed to resolving audits, given the number of valuation issues in which there is no "right" answer.

d) Human Nature I. There is less work involved in drafting an "agreed" audit report for the estate tax examiner than if the matter goes "unagreed" to Appeals.

e) Human Nature II. Most examiners want to be perceived by both IRS management and outside practitioners as people who can resolve differences of opinion.

f) I Can Do What Appeals Can Do. Some examiners feel the IRS Appeals Office will only "give away" the case anyway. They think they can negotiate a better deal at their level based in part on their greater knowledge of the facts. Generally there is more latitude in resolving a factual rather than a legal issue.

g) Nothing to Lose. Although the examiner may be too wedded to his or her view to compromise, there is nothing to lose by asking.

h) Too Tight with Engineer. There may be a reluctance to deviate from the opinion of the valuation engineer with whom the examiner has been consulting.

i) Don't Blame Me. The estate tax examiner can always fall back on the refrain: "I'm not a valuation engineer. I have to rely on my expert."

j) Reduces New Issue Risk. Resolving the issue at the lowest possible level reduces the risk that an issue would be reopened or a new issue raised at a higher level.

B. ESTATE TAX EXAMINER'S SUPERVISOR (GROUP MANAGER)

1. Option. If matters cannot be resolved with the examiner, there is the option of appealing to the group manager.

2. Pros and Cons of Trying to Resolve the Issues with the Supervisor.

a) Rubberstamp? The group manager normally supports the examiner but this request can be useful when the examiner is taking an unreasonable position.

b) Better in Appeals? There is always the question of the likelihood of doing better in Appeals versus what you can achieve at the Exam level.

c) New Issue Threat. Although the group manager is unlikely to raise a new issue, the risk is present anytime a new person reviews the file.

C. APPEALS OFFICE

1. Basics.

a) Thirty-Day Letter. If matters cannot be worked out at either the examiner or supervisor's level, the IRS normally will issue a 30-day letter, giving the estate the opportunity to contest the examiner's findings with the IRS Appeals Office. The estate has 30 days to file a Protest in response to the 30-day letter but extensions are routinely granted. An exception to this 30-day letter procedure is when there is insufficient time for Appeals consideration before the statute of limitations will expire.

b) Protest. Typically, a Protest is filed in response to the 30-day letter, putting the IRS on notice as to why the estate thinks the findings are erroneous. The Protest is the opportunity for the estate to make its best factual and legal arguments. (See IRS Publication 5 which outlines Appeals procedures, including the instructions for the preparation of a Protest.)

c) Informal Process. The Appeals process is informal and generally involves one or two conferences at the IRS Appeals Office, attended by the practitioner representing the estate and the Appeals Officer. The rules of evidence do not apply. Affidavits can be submitted. In a valuation case, a second appraisal can supplement what was previously provided to the examiner.

d) Mission Statement. It is the mission of the Appeals Office to settle cases. Its purpose is "to resolve tax controversies with no litigation on a basis which is fair and impartial to both the government and the taxpayer." In Washington state, 90-95% of all cases in Appeals are settled without litigation.

e) Litigating Hazards. Unlike the Exam Division, Appeals Officers are required to analyze and consider the **hazards of litigation** in the settlement process. In other words, the issue is how will a court react to the arguments.

EXAMPLE: If the Appeals Officer determines that a case could go either way if the matter were to be litigated, the Appeals Officer should agree to a 50/50 split.

f) Straight to Tax Court. The estate has the option of proceeding straight to Tax Court. The estate likely will find itself in Appeals even after the case is docketed in Court, to see if the matter can be settled without litigation.

g) Conference with Supervisor. Although not officially an option, one might consider requesting a meeting with the Appeals Officer's Associate Chief

or Chief, especially if the Appeals Officer is way out of line. The request need not be granted, and in fact, is generally rejected.

2. Pros and Cons of Appeals.

a) Expense. Provides an opportunity for the estate to settle without incurring the expense of litigation.

b) Fresh Look. Allows a review by an Appeals Officer who is not wedded to the case the same as the estate tax examiner may be.

c) Time Pressures. Allows time to settle the case without the time pressures inherent in a docketed Tax Court case. But because the statute of limitations on assessment cannot be extended in an estate tax audit, if the estate proceeds to Appeals without much time remaining on the statute, it is possible that consideration of the case will be rushed or a 90-day letter will be issued.

d) Payment. Defers payment of taxes (but interest accrues).

e) Discovery. Provides an opportunity to get information from the IRS. Discovery in Tax Court is limited.

f) Litigation Options. Keeps tax litigation forum options open, whereas, if the 90-day letter is received, a decision regarding forum must be made immediately.

g) Attorney Fees. Keeps the door open on the possibility of obtaining attorney fees if the case is eventually litigated. To obtain fees, administrative remedies must be exhausted.

h) New Issue. Provides an opportunity for IRS to raise a new issue although this rarely happens in practice.

i) Psychological Aspect. Arguably, fails to provide the psychological advantage that actually filing a case in Tax Court does. Of course, going to Appeals does not waive litigation options.

j) Speedy Resolution. Fails to provide as fast a resolution of the case as by docketing the case in court.

k) Litigation Vehicle. Fails to provide an avenue of settlement if the IRS has designated the case as involving an issue it wants litigated. In such case, going to Appeals would be a waste of time. Such designation rarely occurs in practice. **PRACTICE TIP**: If it does occur, the estate should consider paying the amount at issue and filing a protective claim for refund.

l) Privacy. Preserves privacy because all dealings with the IRS at the Appeals Office level are kept out of the public record, unlike, for example, in a Tax Court case.

m) Case Sent Back to Examiner. Reduces the chance of the case being sent back to the examiner for further development of the facts if the estate proceeds directly to court rather than Appeals.

n) Claim Disallowance. Possibly forecloses the option of going to Appeals if the estate decides to ignore the 30-day letter, and the assessment is made, followed by payment of the tax and a refund claim. Although the IRS normally issues a statutory notice of claim disallowance on a rejected refund claim, there is no guarantee that it will do so when the refund route is chosen. Thus, the Appeals option may be lost (as well as the Tax Court option, although the estate still could proceed to federal district court or the U.S. Court of Federal Claims).

D. MEDIATION/ARBITRATION

The 1998 Tax Act added two alternatives to the dispute resolution process. Either party can elect mediation to attempt to resolve an unsettled case when the Appeals process is over. There is no threshold dollar requirement as in the past. In addition, the IRS is required to establish a pilot program of binding arbitration for cases of all dollar amounts. Under this program, both the taxpayer and the IRS must agree to be bound by the arbitration. While technically a part of Appeals Office dealings, these options may be resorted to **only after the traditional dealings** with Appeals result in no resolution.

1. Mediation. Under procedures to be prescribed by the IRS, either the taxpayer or Appeals can request non-binding mediation of issues remaining unresolved. 1998 Act § 3465(a)(1), amending IRC § 7123(b)(1).

   a) Expansion. This is a codification and expansion of existing procedures in which mediation was available only where there was more than $10 million in dispute.

   b) Procedures in the Works. It will take the IRS some time to develop procedures for mediation. In November of 1998, the Service expanded its mediation program to allow taxpayers to request mediation **for factual issues** involving an adjustment of $1 million or more that are already in the Appeals administrative process. Announcement 98-99, 1998 I.R.B. 1. This is part of a two-year test program the procedures for which follow.

   c) No $1 Million Limit. Although Announcement 98-99 limits the availability of mediation to cases involving adjustments of $1 million or more, there is some indication that the IRS is willing to expand the test program to include cases involving smaller amounts.

   d) The Process. Under the mediation procedure, the taxpayer and Appeals will continue to negotiate a settlement but an objective and neutral third-party mediator will assist them. The mediator has no authority to impose a decision.

   e) Fact Issues. Factual issues include valuation, reasonable compensation and transfer pricing.

   f) Traditional Appeals Option Must be Exhausted. The procedure may be used only after Appeals settlement

negotiations are unsuccessful, and when all other issues are resolved but for the issue(s) for which mediation is being requested.

g) Limitations. Mediation under these procedures is **not available** for an issue designated for litigation or **docketed in any court**, an Industry Specialization Program (ISP) issue, an Appeals Coordinated Issue or an issue where taxpayer has filed a request for competent authority.

h) Mediators. The test of mediation procedures for Appeals seeks to include cases using both non-IRS and Appeals personnel as mediators. The procedures approve of the use of any local or national organization that provides a roster of neutrals in selecting a mediator.

i) Costs -- IRS Mediator. When an Appeals employee is selected as mediator, the person shall be from another Appeals region or the National Office of Appeals. If the parties select an Appeals mediator (or co-mediator), Appeals will pay the expenses associated with the mediator.

j) Costs -- Non-IRS Mediator. When the parties select a mediator from outside the IRS, the taxpayer and Appeals share equally the expenses associated with the mediator.

k) Denial of Mediation Request. Although no formal procedure exists for the denial of a mediation request, a taxpayer may request a conference to discuss the denial.

l) Discussion Summaries. Each party is to prepare a discussion summary of the issues (including the party's arguments in favor of the party's position) for consideration by the mediator. The discussion summaries should be submitted to the mediator and the other party no later than two weeks before the mediation is scheduled to begin.

m) Two-Year Test. The Announcement 98-99 procedures outlined above are effective for requests for mediation made during the two-year test period beginning November 16, 1998.

n) Model Agreement. A Model Agreement to Mediate is included as an exhibit to Announcement 98-99.

o) **PRACTICE TIP**: These provisions may prove to be very

valuable in resolving estate and gift disputes given that valuation issues are the perfect candidate for mediation. The estate is given an additional chance to get a matter resolved without having to incur the expense of litigation.

2. Arbitration. The IRS is required to establish a pilot program under which the taxpayer and the Appeals Office can jointly request binding arbitration on issues remaining unresolved. 1998 Act § 3465(a)(1), amending IRC § 7123(b)(2).

   a) Test Program. In Announcement 2000-4, the IRS announced that a two-year test period for arbitration begins for requests made on or after January 18, 2000.

   b) Fact Issues. Arbitration is available only for factual issues, such as valuation and reasonable compensation.

   c) Limitations. Although arbitration is voluntary on both sides, each party forgoes the right to judicial review if arbitration is elected.

   d) Traditional Appeals Option Must be Exhausted. The procedure can be used only after normal channels within Appeals are exhausted.

   e) Arbitrator. The procedures for selection of an arbitrator and for payment of costs are similar to those for mediation.

3. Pros and Cons.

   a) Expense. Less expensive way to resolve issues than through litigation.

   b) Fresh Look. Provides the opportunity for further review of the file when the goal is to find someone who will take a realistic look at the issue.

   c) Valuation Cases. Provides one more option to avoid the wrath of the judge who does not want to be bothered with a valuation case.

   d) Little to Lose. With mediation, there is little to lose in trying with the exception of splitting the cost of a

non-IRS mediator and paying any professional fees.

E. LITIGATION

Estates are fortunate to have three forums to choose from in appealing an adverse IRS audit determination. In addition, appeals can be taken to the appropriate Circuit Court if the trial court result is unfavorable. Finally, a Circuit decision can be appealed to the U.S. Supreme Court. The appeal of an adverse trial court decision is beyond the scope of this outline.

1. General Considerations.

a) 90-Day Letter. If a settlement cannot be reached with the IRS Appeals Office, if an estate decides not to respond to an IRS 30-day letter or if the statute of limitations is about to expire, a statutory notice of deficiency (90-day letter) will be mailed to the estate. The 90-day letter is the Service's final determination of the amount due and owing. It is the estate's "ticket to Tax Court."

b) Choice of Forum. Tax Court is not the only forum available if an estate wishes to dispute an IRS audit determination. The U.S. Court of Federal Claims and federal district court are also possibilities.

c) Payment. An estate that is unable to pay the amount in dispute has no choice but to litigate in Tax Court. Since most taxpayers prefer to fight first, and pay later, Tax Court is generally the forum of choice.

d) Precedent. Precedent is an important factor in choosing a forum. A careful analysis of the pertinent case law must be made.

e) Jury Trial. Federal district court is the only forum in which a jury trial may be had. A jury trial can be advantageous when the law is not developing as desired but the equities are on the estate's side.

f) Tax Expertise. If a case involves a sophisticated issue of tax law, Tax Court judges have the most tax law expertise. Tax cases make up approximately 30% of the Court of Federal Claims cases. Federal district court judges generally have little or no

federal tax expertise.

g) Additional Factors. Additional factors in choosing the appropriate court include differences in discovery, in the amount of publicity a case is likely to get, in the use of stipulations, and in potential exposure to new issues being raised by the IRS.

2. U.S. District Court.

a) Jury Trial. As noted above, the U.S. District Court is the only court in which a jury trial can be had.

b) Payment is Prerequisite. In order to litigate in federal district court, the amount in dispute must be paid beforehand.

c) Claim for Refund. After the amount in dispute is paid, the taxpayer files a claim for refund.

d) Suit After Disallowance of Claim. When the claim for refund is disallowed, or six months passes from the filing of the claim, the taxpayer may then file suit.

e) Few Cases. Relatively few tax disputes are litigated in federal district court. Of the 27,000 tax cases decided in 1998, approximately 600 were federal district court cases.

f) Justice Department Attorney. The government is represented by a lawyer from the Tax Division of the Justice Department in Washington, D.C.

3. U.S. Court of Federal Claims.

a) Payment is Prerequisite. The payment of the amount in dispute and the filing of a claim for refund are also prerequisites to filing a suit in the U.S. Court of Federal Claims.

b) Where Based. The U.S. Court of Federal Claims is a national court based in Washington, D.C.

c) Place of Trial. A Court of Federal Claims trial may take place in Washington, D.C. or the judge may

travel to one or more cities to take testimony and receive evidence.

d) Percentage of Tax Cases. As noted above, approximately 30% of the cases pending before the Court are tax cases. In 1998, the Court decided approximately 150 tax cases.

e) Justice Department Attorney. The government is represented by a lawyer from the Tax Division of the Justice Department in Washington, D.C.

2. U.S. Tax Court.

a) Forum of Choice. Statistically, the Tax Court is the forum of choice. Of the 27,000 tax cases decided in 1998, approximately 26,000 were decided by the Tax Court. The main reason the Tax Court is favored is that it is the only court in which tax liability can be litigated without the necessity of the taxpayer first paying the amount in dispute.

b) Where Based. The Tax Court is based in Washington, D.C., although it regularly conducts trials and hearings in cities throughout the United States.

c) Judges. There are currently 19 presidentially appointed judges on the Tax Court. Each serves for a term of 15 years. Cases also can be heard by special trial judges or by retired senior judges.

d) 90-Day Letter Is Prerequisite. It is a jurisdictional prerequisite that prior to going to Tax Court, the IRS must send the taxpayer a 90-day letter. **PRACTICE TIP**: If an estate pays the deficiency amount **prior to** receiving a 90-day letter, the estate has eliminated the Tax Court as a possible forum. A deposit, as opposed to a payment, stops the accrual of interest to the extent of the deposit, without loss of the Tax Court option.

e) Mailing of Petition. The taxpayer must file a petition with the Tax Court within 90 days after the date of mailing of the 90-day letter. Traditionally, the best way to ensure that a petition will be deemed

timely filed was to have a U.S. Postal Service postmark stamped on the envelope. Standard advice has been to send the petition to the U.S. Tax Court by certified mail, so that there is a receipt stamped by the post office showing the date of mailing. Recently, there has been a change in the law. Some private companies that deliver mail now qualify under the "timely mailing is timely filing" rule that applies to the Tax Court petition.

f) Controlling Precedent. The Tax Court considers itself bound by the law of the United States Court of Appeals that has appellate jurisdiction with respect to a specific Tax Court case. In the absence of such authority or a U.S. Supreme Court decision, the court does not consider itself bound by the decision of any other court.

g) Request for Place of Trial. When the petition is filed, generally a request for place of trial is also filed. If, for example, Seattle is requested, the Tax Court will forward a copy of the petition to the Seattle District Counsel's office for assignment to an IRS attorney.

h) Burden of Proof. Traditionally, the burden of proof has been on the taxpayer with a few exceptions. For example, the Tax Court rules provide that the burden of proof is on the IRS with respect to fraud, new matters raised, and increases in deficiencies. The 1998 Tax Act puts the burden of proof on the IRS in court proceedings as to any factual issue if the taxpayer 1) introduces credible evidence on the issue; 2) complies with certain substantiation requirements; 3) maintains all required records; and 4) cooperates with reasonable IRS requests. Corporations, partnerships and trusts with a net worth exceeding $7 million are not eligible for this provision. The new rule applies to court proceedings arising in connection with examinations commencing after July 22, 1998.

i) Rules of Evidence. The Tax Court uses the Federal Rules of Evidence in its proceedings.

j) Rules of Procedure. Although the Tax Court has its

own procedural rules, they are patterned after the Federal Rules of Civil Procedure. There are significant differences regarding discovery. Also, the Tax Court rules allow the issuance of a subpoena to compel the attendance of witnesses or the production of documents and other evidence from any place in the United States.

k) Settlement. Even though a case has been filed in Tax Court, it may very well be referred to the IRS Appeals Office so that settlement can be pursued. If the case previously has been considered by Appeals, it will be referred to Appeals only if District Counsel's office believes there is a good reason to do so. If the case is not settled by the Appeals Officer, the Appeals Officer transfers the case back to District Counsel, so that the IRS lawyer has time to prepare the case for trial.

l) Stipulations. Pursuant to Tax Court Rule 91(a)(1), the parties are required to develop to the extent possible a statement of all facts not in dispute which are relevant to the pending case. The idea is to cut down on the amount of time needed to present facts at trial. The stipulation process must be pursued in good faith before the parties resort to discovery.

m) Discovery. Although the Tax Court rules governing discovery are based on the Federal Rules of Civil Procedure, they are not as broad. As previously mentioned, the Tax Court rules mandate that the parties employ the stipulation process. In this regard, the rules contemplate informal discussions and exchanges of information and documents prior to resorting to formal discovery. The rules governing the use of interrogatories are generally similar to the Federal Rules of Civil Procedure, except with respect to expert witnesses. Discovery depositions are allowed but only in limited circumstances. With the consent of all parties to the case, a deposition for discovery purposes may be taken either of a party or a non-party witness. Depositions of non-party witnesses may be allowed without consent of all the parties, but only in extraordinary circumstances after all attempts to obtain the evidence informally, through the

stipulation process or under the consensual deposition rules, have failed. The rules also provide for requests for production and requests for admissions.

n) Pretrial Order. Tax Court judges employ standard pretrial orders that are sent when a trial calendar date is set. The pretrial order establishes timetables for the completion of discovery, submission of stipulations, filing of pretrial memoranda, and deals with other preliminary matters. A formal pretrial conference generally is not necessary in most deficiency proceedings.

o) Trial Calendars. The Tax Court generally conducts one or two calendar calls per year in locations where it sits. For example, in Seattle in recent years, there has been one regular trial calendar each year. These trial sessions usually last one to two weeks. The calendar call typically takes place on the first day of the trial session. A tentative schedule for the trial of all cases called generally will be determined, and preliminary matters will be dealt with.

p) Trial. In general, the trial of a Tax Court case proceeds in the same manner as a trial conducted in any other federal court.

q) Briefing. When the trial concludes, the judge sets a briefing schedule for the parties. In the briefs, the parties propose findings of fact (citing the trial transcripts or filed stipulations) and make their legal arguments. It would not be uncommon for a judge to take up to one year to issue an opinion after the briefs are filed.

r) Small Case Procedure. The Tax Court rules permit a taxpayer contesting a tax deficiency of $50,000 or less to elect the use of small case procedures. (This amount was increased from $10,000 by the 1998 Tax Act.) If this procedure is elected, the trial is conducted in a more informal manner than in a regular Tax Court proceeding. If the small tax case procedure is elected, there is no appeal from a decision of the court. The trials are conducted before a special trial judge. The court will accept

any evidence which it determines has probative value. Most taxpayers appear without counsel. Generally, briefs are not required.

5. Pros and Cons of Litigation.

a) Expense, Stress and Time. Litigation of a tax case is no different from other litigation -- it is expensive, stressful and time consuming.

b) Valuation Issues. Judges tend not to like to deal with valuation issues. Judges think that these cases should be settled and some will go to great lengths to see that they are settled.

IV. STRATEGIES IN GETTING YOUR CLIENT A BETTER RESULT

A. KNOW YOUR ADVERSARY

Time spent finding out about the estate tax examiner's or Appeals Officer's background and experience, and how the person thinks, can be important.

EXAMPLE: Although in many parts of the country the Appeals Officer who handles estate tax matters may be an attorney, this is not currently the case in Washington.

OTHER EXAMPLES: Will the estate tax examiner split or trade issues despite this being beyond his or her authority? Does the Appeals Officer generally make a settlement proposal or expect the estate to make one first? How does the Appeals Officer like to conduct the conference? Does the Appeals Officer tend to raise new issues? Does the Appeals Officer tend to send matters back down to Exam for further factual development?

B. KNOW THE RULES BY WHICH YOUR ADVERSARY IS BOUND

The IRS manual should be consulted. This is what the IRS employees use for guidance on issues. It is the starting point. For example, as noted above, the IRS publishes a handbook called the "Examination Technique Handbook for Estate Tax Examiners" for use by its estate and gift tax attorneys.

C. TREAT YOUR ADVERSARY IN A PROFESSIONAL MANNER

IRS employees are human beings, too. Most are simply trying to do their job as best they can. Personal attacks only strengthen their resolve.

PRACTICE TIPS:

1. De-personalize. You can attack the "examination report" rather than the examiner.

2. No Surprises. Avoid arguing the law in a meeting without providing the person with advance notice or something in writing.

3. Don't Ask Too Much. Keep in mind that your adversary has deadlines to meet and restrictions on the amount of time to deal with the case.

4. Recognize Person Works for IRS. Despite the above, never forget that your adversary, even if you are dealing with an Appeals Officer, is an IRS employee.

D. MAKE YOUR ADVERSARY'S JOB EASIER

1. Draft the Supporting Statement. Do the Appeals Officer's work to the extent possible. The Appeals Officer is required to write up a statement supporting the settlement position in order to convince the Chief or Associate Chief to sign off. A well-reasoned and well-written Protest may provide what the Appeals Officer needs to write the statement.

   PRACTICE TIP: Sometimes the Appeals Officer has concerns that are not addressed in the Protest. Ask the Appeals Officer if it would be helpful to put something in writing for possible inclusion in the statement.

2. Provide Copies of Authorities. Appeals Officers and examiners may not have ready access to the research materials you have. Provide favorable research authorities to your adversary to help ensure that they get read.

E. BE ALERT TO NEW ISSUES

1. The Problem. Part of getting your client a better result is to make sure that your client is not worse off by pursuing an appeal through

the system. The IRS can raise a new issue (or reopen a resolved one) so long as the statute of limitations (which is tolled while the estate is in Tax Court) has not expired. Watch out at the Tax Court level especially.

EXAMPLE: The estate tax examiner raises only a valuation issue involving $200,000. The estate files a Protest in response to the 30-day letter. In the conference, the Appeals Officer decides to raise the family limited partnership issue which involves $750,000 and which was discussed only briefly with the estate tax examiner. Instead of $200,000 being in dispute, there is nearly $1,000,000 in dispute.

2. Preparation. Review the return in question to know and understand the risks of a new issue being raised. Sometimes it is better to settle a case on less favorable grounds than run the risk of a new issue being raised.

3. The Standard. New issues are not raised often. The IRS manual provides that it is not IRS policy to raise a new issue unless the grounds are "substantial" and the potential effect on the tax liability is "material." Appeals Officers are **not** to raise new issues for bargaining purposes.

4. Strategy. The taxpayer should consider refund rather than deficiency procedures. In other words, the estate should pay the tax, file a refund claim and pursue the matter either in district court or the U.S. Court of Federal Claims. When the estate files a refund claim after the statute of limitations on assessment has expired, the IRS may raise a new issue only to offset any recovery by the estate. In other words, the new issue cannot be used affirmatively to collect additional tax.

   EXAMPLE: In the example above, the IRS could prevent the estate from recovering the $200,000 sought if it prevailed on the $750,000 issue, but it could not collect any additional balance.

5. Malpractice. There is a tendency to think that there is no downside in going to Appeals and although this is generally true, it is not always the case. Anytime Appeals is viewed as an option, the possibility of a new issue being raised needs to be discussed with the client.

F. INVOLVE AN EXPERT

Involve an expert, particularly on a valuation issue. This may carry greater weight than one would otherwise expect particularly given the difficulty the IRS has in getting qualified experts of its own.

G. LEAVE YOUR CLIENT AT HOME

Should the practitioner allow the personal representative to attend meetings with the examiner or the Appeals Officer?

1. Reasons Not to Attend Alone. Generally, the IRS would prefer to go directly to the source for obtaining information rather than ask questions through the person handling the audit. Also, sometimes the practitioner is tempted to bring the personal representative to a meeting with the examiner or to an Appeals conference **to serve the practitioner's needs**. This might give the personal representative a better understanding for why concessions have to be made. In addition, sometimes the personal representative has first-hand knowledge that could be helpful in trying to persuade. Finally, some personal representatives want to be involved in the process.

2. Reasons to Attend Alone. Considerations include the possibility that the IRS person will feel "ganged up" on, and that the personal representative will not understand the issues, will be nervous, will talk too much, and will volunteer information. In an estate tax exam, there is the added risk that the examiner will display a negative attitude toward the decedent or the decedent's assets which might result in the personal representative being overly emotional or perhaps being offended, saying something that would be regretted later. In addition, the IRS person may be more candid when the personal representative is not present.

3. Further Consideration. Another consideration is that the personal representative who has first-hand knowledge is subject to questioning and may be expected to know the answer. If, on the other hand, only the practitioner is present, the practitioner can postpone answering until checking with the client.

4. **PRACTICE TIP**: As a general rule, leave the personal representative at home. If the personal representative wants to attend, consider working out ground rules with the

examiner or Appeals Officer in advance. For example, it could be agreed that the personal representative would be there only as an observer _neither to ask questions nor be asked.

5. **PRACTICE TIP**: If the personal representative is going to be present at a meeting, the practitioner should prepare the person similar to preparing a witness for trial. The same would be true if an expert in a valuation dispute were to be in attendance.

6. **PRACTICE TIP**: Sometimes the examiner will want to interview the personal representative or someone with first-hand knowledge. The only way an examiner can **require** the attendance of the personal representative or anyone else for an interview is to serve a summons on the person. The best way to avoid such a request is for the practitioner handling the audit to be well prepared. Generally, the IRS will not insist on interviews so long as it is getting from the practitioner timely responses to questions. If the practitioner is not knowledgeable or does not get the answers, the IRS will insist on going directly to the source.

H. PREPARE/KNOW THE FACTS AND LAW BETTER THAN YOUR ADVERSARY

The estate has the advantage of having better access to the facts than does the IRS. The estate also sometimes has better access to research authorities and materials than do IRS employees whose resources are limited by budgetary considerations. This can be a powerful weapon in negotiations and litigation.

PRACTICE TIPS:

1. Ask Why Selected for Exam. Find out why the return was selected for audit.

2. Know the Law. Know the precedent in each forum well enough that the Appeals Officer can be told in which court the estate will file if the matter is not resolved.

3. Prepare for Trial. Where the dollars warrant it, prepare the case as if going to trial. Anticipate and understand the IRS side of the issue.

4. Request Examiner's Rebuttal. In Appeals, ask for a copy of

the estate tax examiner's rebuttal to the Protest.

5. Inquire About Concerns. Call the estate tax examiner or Appeals Officer in advance to ferret out any concerns prior to meeting.

6. Update Research. Because several months can go by between the filing of the Protest and the conference, the practitioner should update any research before the conference.

7. Evaluate Strengths and Weaknesses. The practitioner should evaluate with a critical eye the strengths and weaknesses of the arguments. The practitioner should analyze the case from the standpoint of what arguments would be made if the practitioner were arguing the IRS side.

8. Convey Conviction. It is important that the practitioner convey a belief that the estate's position is correct. If it takes time to develop this conviction, the time must be spent.

9. Consider Alternative Settlement Proposals. Generally, an Appeals Officer will not have done computations in advance, and even if done, the Appeals Officer is unlikely to take into account all the collateral consequences of a settlement — e.g., the income tax ramifications that might be involved. The practitioner may be able to propose a settlement that appears to be a larger concession than it actually is.

10. Be Prepared to Make the Opening Offer in an Appeals Conference. The practitioner should not count on the Appeals Officer's willingness to go first.

11. Consider FOIA Request. Consider making a Freedom of Information Act request to find out what is in the IRS file.

I. LISTEN TO THE IRS PERSON

Listen and be sure you understand the position of the IRS. The IRS person wants to be heard. Focus on him or her. Your goal is to get the person with whom you are dealing to agree with you, because chances are the supervisor will sign off on the matter.

J. CONSIDER SEEKING TECHNICAL ADVICE

Requesting that technical advice be sought is a form of appeal. If the estate disagrees with the estate tax examiner or the Appeals Officer, a request can be made that the opinion of the IRS National Office be sought. Such requests are not often made. The process can be quite lengthy. The examiner is bound by technical advice. Although the Appeals Officer is not bound, typically great deference is given to such advice.

K. ACT IN AN ETHICAL MANNER

The practitioner's reputation and credibility are important factors in getting the estate a favorable result. Ethical considerations include:

1. Penalties of Perjury. The instructions for preparation of the Protest require that there be a statement comparable to the following: "Under the penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and statements and, to the best of my knowledge and belief, it is true, correct, and complete."

2. Duty to Volunteer Authorities. There is no duty to point out authorities that an examiner or Appeals Officer has missed. Dealings are treated similarly to dealings with opposing counsel as opposed to duties owed to a court. Formal Opinion 314, American Bar Association.

3. Prohibition on Delay. Section 10.23 of Circular 230 prohibits unreasonably delaying the prompt disposition of any matter before the IRS.

4. Due Diligence. Section 10.22 of Circular 230 requires that an attorney, CPA or enrolled agent shall exercise due diligence in determining the correctness of oral or written representations made.

5. Duty Not to Mislead. Regarding the negotiation of settlements, "the lawyer is under a duty not to mislead the Internal Revenue Service deliberately or affirmatively, either by misstatements or by silence or by permitting his client to mislead." Formal Opinion 314, American Bar Association.

L. FOCUS ON THE LITIGATING HAZARDS

Unlike examiners, Appeals Officers are required to analyze and consider the hazards of litigation in the settlement process. To obtain a favorable settlement, the estate's goal is to demonstrate that the IRS would lose in court if the matter were to go to trial.

PRACTICE TIPS:

1. Put the examiner's report (rather than the examiner) "on trial" at the higher levels.

2. IRS employees tend to be impressed with revenue rulings and private letter rulings. Use them to your advantage.

3. Forget relying on the equities and forget arguing frivolous issues. Litigating hazards are the key to settlement. The same rule applies at the litigation stage.

M. ARGUE BURDEN OF PROOF

The new burden of proof provision supplies estates with an additional "litigating hazards" argument during settlement negotiations.

1. Burden of Proof Argument. The 1998 Act places the burden of proof on the IRS in any court proceeding as to factual issues if the estate introduces credible evidence on the issue and meets four requirements:

a) Complies with substantiation requirements;

b) Maintains all required records;

c) Cooperates with reasonable IRS requests; and

d) Is not a corporation, trust or partnership with a net worth exceeding $7 million.

2. Provisions of New Law.

   a) The Basics. IRC § 7491(a) sets forth the basic requirements that are listed above.

   b) "Credible Evidence." Means a quality of evidence sufficient to base a decision on the issue if no contrary evidence were submitted without regard to the general presumption of correctness accorded the

IRS determination.

c) "Substantiation Requirements."

Includes:

(i) Those imposed generally. **EXAMPLES**: Requirement that taxpayers maintain records; requirement that U. S. persons furnish information on controlled foreign businesses.

(ii) Those imposed as to specific items. **EXAMPLES**: Requirements relating to charitable contributions; requirements relating to meals, entertainment or travel.

(iii) Any requirement of the Code or Regulations that the taxpayer establish an item to the satisfaction of the IRS.

d) Loss or Destruction of Substantiation.

(i) An estate which destroys the required substantiation cannot shift the burden of proof to the IRS.

(ii) If the estate establishes that the substantiation was lost or destroyed through no fault of the estate, existing rules regarding reconstruction of records would apply.

e) Cooperation with IRS.

Includes:

(i) Providing access to and inspection of witnesses, information and documents, which are within the taxpayer's control within a reasonable time.

(ii) Providing reasonable assistance to the IRS in obtaining access to and inspection of witnesses, information and documents, which are not within the estate's control.

(iii) Establishing the applicability of any privilege.

(iv) Exhausting all administrative remedies, including Appeals.

f) Non-eligible Taxpayers.

Corporations, partnerships, and trusts whose net worth exceeds $7 million are not eligible for this burden of proof provision. There appears to be no such limitation on the size of an estate. In other words, all estates, no matter their size, appear to qualify for a potential shift in the burden of proof. See, e.g., General Explanation of Tax Legislation Enacted in 1998 ("Blue Book"), Nov. 24, 1998, prepared by the staff of the Joint Committee on Taxation.

g) Miscellaneous.

(i) New rule does not apply to any issue with respect to which another Code section provides for a specific burden of proof.

(ii) The estate has the burden of proving the conditions of eligibility set forth above.

3. Practical Effect of Burden of Proof Provision.

a) Tie to Estate. When the burden of proof is on the IRS and the evidence is equally weighted, the tie goes to the estate. Under the old law, a tie went to the IRS.

PRACTICE TIP: The burden of proof may be important in a valuation dispute where a judge has a hard time deciding between two equally competent experts who disagree.

b) Additional Leverage. Estates have an extra arrow in their quiver in their dealings with Exam and Appeals. If the IRS has doubts about its ability to meet its burden of proof, the estate acquires additional leverage. This may be particularly helpful in valuation cases.

PRACTICE TIP: The estate may be able to obtain a more favorable settlement by arguing that the IRS

litigation hazards are increased because of its burden of proof.

c) Back to Exam for Further Development. Appeals may send more cases back to Exam for further development.

d) Higher Costs. The provision is likely to lead to higher costs. Practitioners will be under pressure to make sure that the cooperation requirement is not blown as a result of their own action or inaction. Practitioners may feel pressure to go out of their way to respond to IRS requests and to document their files regarding same. There also will be higher costs associated with the requirement that administrative remedies be exhausted.

e) Extensive Development of Issues. There may be more extensive development of issues by the IRS estate tax examiner which also will lead to higher costs for the estate. The concern is overly intrusive audits as the IRS prepares to meet its burden.

f) Malpractice Traps. The estate that loses and concludes that the lack of the burden of proof being placed on the IRS played a key role, may blame the practitioner for the estate's shoddy record keeping or blame the practitioner for failing to cooperate with the IRS.

PRACTICE TIP: Discuss the cooperation issue with the client and document the issue.

4. Effective Date.

Effective for court proceedings arising in connection with examinations commencing after the date of enactment (July 22, 1998).

N. MAKE A QUALIFIED OFFER

On the issue of litigating hazards, estates have additional leverage in Appeals because of a greater threat that the IRS will have to pay attorney fees and costs. This provision applies only to estates with a net worth not exceeding $2 million. In the past, awards of attorney fees have been rare, particularly because there was no award if the IRS position was "substantially justified." Although fees still generally are limited to far below market rates, a new provision provides that if beginning during Appeals negotiations, the IRS turns down a settlement proposal and then does not do better in court, the IRS pays attorney fees.

1. 1998 Act. The 1998 Act provides that an estate otherwise meeting the requirements for entitlement to fees or costs will be treated as a "prevailing party" if the liability determined in a court proceeding is equal to or less than what the estate's liability would have been had the United States accepted a "qualified offer." 1998 Act § 3101(e), amending IRC § 7430(c)(4)(E)(i).

a) Definition. "Qualified offer" is defined as a written offer which:

(i) Is made by the estate during the "qualified offer period."

(ii) Specifies the amount of the estate's liability without interest.

(iii) Is designated as a qualified offer.

(iv) Remains open during the period beginning on the date on which it is made, and ending on the earliest of the date on which the offer is rejected,

the date on which trial begins, or the 90th day after the offer is made.

b) Qualified Offer Period. Defined as the period that begins on the date the IRS sends the first letter of proposed deficiency which affords the opportunity for administrative review with Appeals, and which ends 30 days before the date set for trial.

c) Result. Offers made by estates during consideration of their cases by Appeals could provide a basis for an award of attorney's fees and costs, if a court judgment determines a liability equal to or less than that of the liability which would have resulted had Appeals accepted the estate's offer.

d) Subsequent Costs Only. Reasonable administrative and litigation costs paid by the government shall include only costs incurred on and after the date of the qualified offer. Thus, **the earlier the offer is made, the larger the potential recovery of costs.**

e) Last Offer Controls. If more than one qualified offer is made, it is the last one which controls.

f) Prevailing Party. The qualified offer rule allows the estate to qualify as a "prevailing party" without substantially prevailing on the amount in controversy or the most significant issue. Estates also will not have to argue about whether the position of the Service was substantially justified.

g) Legislative History. The Committee Reports state: "The Committee believes that settlement of tax cases should be encouraged whenever possible." This provision should provide incentive to both the taxpayer and the IRS to get cases settled.

h) Limitations. The provision **does not provide for payment of fees and costs in a case which is settled** nor does it cover cases in which no tax liability is in controversy (e.g., declaratory judgment and summons enforcement proceedings).

i) Old Rules. The "qualified offer" provision does not prevent an estate from qualifying as a "prevailing party" under the old rules.

j) Disclosure. Estates need to consider the amount of disclosure that they make in connection with a qualified offer so as not to run afoul of the exhaustion of administrative remedies rule or the prohibition on protracting the proceedings.

EXAMPLE: A fee award could be denied if the IRS were able to argue successfully that it would have settled the case for the qualified offer amount had the taxpayer disclosed certain information in its possession.

k) Federal Rules. The provision is patterned after Rule 68 of the Federal Rules of Civil Procedure.

l) Favorable Provision. It is the estate which controls the timing and the amount of the qualified offer. It is the IRS that has a downside in rejecting an offer.

m) Timing of Offer. The pros and cons of whether to make a qualified offer in a particular case should be discussed with any client who does not exceed the net worth limitations anytime a matter goes to the IRS Appeals Office. As a practical matter, there may be a reluctance to make a qualified offer prior to sizing up, for example, the IRS Appeals Officer's view of the issue. In other words, the Appeals Officer may not share the practitioner's pessimistic view of the estate's litigating hazards.

n) Net Worth Limitation. For both trusts and estates the $2 million net worth limitation for individuals is applicable. The net worth of an estate for purposes of applying the limitation is determined as of the date of death; the net worth of a trust is determined as of the end of the last day of the trust's taxable year which is at issue.

2. Practical Effect. IRS employees have lived in an environment in which the payment of attorney fees by the IRS is abhorrent because it suggests that an IRS employee did something wrong. The threat of fees and costs being paid by the IRS should help keep IRS settlement offers realistic. The provision could be particularly useful when an Appeals Officer is taking an unrealistic position on a matter. More tax cases are likely to be settled as a result of this provision.

3. Effective Date. This provision applies to costs incurred after January 18, 1999.

O. REFER UNRESOLVED ISSUES FROM THE EXAMINATION DIVISION TO APPEALS EVEN WHILE STILL WORKING WITH EXAM

1. 1998 Act. The new law permits any taxpayer to request early referral of one or more issues from Examination to Appeals. 1998 Act § 3465, amending IRC § 7123.

2. Expansion and Codification of Program. This is an expansion and codification of an early referral program which previously had permitted early referral only in regard to limited categories of taxpayers or issues.

3. Taxpayers' Option. Early referral is optional and initiated by the taxpayer.

4. Revenue Procedure. Rev. Proc. 99-28, I.R.B. 1999-29, describes the method by which a taxpayer may request early referral.

5. Practical Effect. If there is an issue or two not likely to be resolved in Exam, the estate has the option of moving the issue(s) to Appeals even while continuing to work on resolving the other issues.

P. KEEP AN EYE ON THE APPEALS OFFICER'S DEALINGS WITH THE ESTATE TAX EXAMINER

1. "No Contact Rule". The 1998 Act includes provisions on restructuring the IRS. As part of the restructuring, the IRS is required to insure an independent Appeals function within the IRS. Therefore, the IRS reorganization plan must prohibit ex parte communications between Appeals Officers and other IRS employees to the extent that such communications appear to compromise the independence of Appeals Officers. 1998 Act § 1001(a)(4).

2. Practical Effect. Discussions between the estate tax examiner and the Appeals Officer should be substantially curtailed. IRS guidance on this issue is expected.