# TRIALS & TRIBULATIONS:
# DEFENDING TRANSFER TAX RETURNS IN AUDIT

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## I. INTRODUCTION

The steps that partners and their advisors take in forming and operating a family limited partnership[1] can impact a court's view on valuation to such a great extent that valuation evidence can become irrelevant. In transfer tax cases addressing legal issues such as indirect gifts and the applicability of § 2036,[2] courts may conclude that the facts in a given case are such that it is a proportionate share of the assets of the partnership, rather than the transferred partnership interest, that is to be valued for transfer tax purposes. In other words, if the existence of the partnership is judicially disregarded, the question of the value of the transferred partnership interest need not be reached – only the value of the underlying assets of the partnership matters. The result to the taxpayer in such a situation is that although he transferred a partnership interest subject to various duties and restrictions found in the governing partnership agreement, for transfer tax purposes, those duties and restrictions are ignored, and the resulting discounts for lack of marketability and lack of control are disregarded. Thus, when the existence of a partnership is judicially ignored, the value that is used for transfer tax purposes is the portion of the underlying assets of the partnership attributable to the transferred interest, without regard to the fact that a hypothetical buyer would take into account the terms of the partnership agreement when deciding on the price that he would be willing to pay for the interest.

As the Internal Revenue Service ("the IRS") increases its efforts to deprive taxpayers of the tax benefits that family limited partnerships offer, a pattern of issues raised by the IRS has emerged. For instance, in recent cases, the IRS has focused on whether Internal Revenue Code § 2703 applies to disregard rights of first refusal and buy-sell provisions when determining the value of a partnership interest that was transferred. *Fisher v. United States*, 2010 WL 3522952 (S.D. Ind. Sep. 1, 2010); *Holman v. Comm'r,* 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010). The IRS also generally argues that the fair market value of partnership interests reported on various transfer tax returns is too low – that the valuation discounts applied were too aggressive or simply were not applicable.

In the gift tax context, the IRS has focused on whether gifts of partnership interests can qualify for the annual gift tax exclusion and whether gifts of partnership interests made close in time to the partnership's formation are, instead, gifts of underlying assets of the partnership that were then contributed to the partnership by the gift recipient (the indirect gift theory). For instance, in a case where a father and his two sons created a partnership, and the father, at creation, transferred all of the assets to

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1 Although this article refers to limited partnerships, many of the suggestions contained herein also apply to other closely held entities, such as limited liability companies.

2 The author has attempted to provide a thorough analysis, for educational purposes only, of the arguments that the IRS has made and the courts have sometimes adopted in addressing certain "pitfalls" in the structure and operation of family entities. However, no statement herein should be construed as a concession of the legal sufficiency of those analyses or that any such "pitfall" precludes recognition of the entity for any federal tax purposes.

the partnership (and the sons made no individual capital contribution), the Tax Court held that the father had not made gifts of partnership interests, but rather made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent that those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376 (2000), ***aff'd,*** 283 F.3d 1258 (11th Cir. 2002). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. *See also Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009); *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), ***aff'd***, 433 F.3d 1044 (8th Cir. 2006); *Holman v. Comm'r,* 130 T.C. 170 (2008), ***aff'd***, 601 F.3d 763 (8th Cir. 2010); *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008).

And in the estate tax context, the IRS has increasingly raised the spectre of IRC § 2036(a). Typically, the IRS has argued that all assets contributed by a decedent to a limited partnership during lifetime should be included in the decedent's gross estate under § 2036(a)(1), arguing that the decedent retained rights to assets contributed. Most recently, the IRS successfully argued that a decedent's retention of the right to dissolve a partnership, in conjunction with another person, caused § 2036(a)(2) inclusion – an argument on which the IRS had not been successful since *Estate of Strangi*, 85 T.C.M. (CCH) 1331 (2003), ***aff'd*** 417 F.3d 468 (5th Cir. 2005). The IRS's most recent attack on partnerships is becoming commonly referred to as "the marital deduction mismatch." *See, e.g., Estate of Turner v. Comm'r*, 138 T.C. No. 14 (2012) (limiting the decedent's marital deduction to the actual value of the property passing to the wife, where the will provided for a calculation based upon the actual, rather than discounted value, of the assets); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010) (declining to reach the marital deduction mismatch argument because the exception to § 2036 applied).

In determining fair market value for transfer tax purposes, the value of a transferred interest is determined according to the "hypothetical willing buyer/willing seller" test found in § 2031 (for estate tax purposes) and § 2512 (for gift tax purposes) and the related Treasury Regulations. *See Ludwick v. Comm'r*, 99 T.C.M. (CCH) 1424 (2010) (determining fair market value of undivided interest for gift tax purposes). Therefore, the fair market value of the transferred interest is not a proportionate share of the partnership's assets, because a hypothetical willing buyer would not be willing to pay for a pro rata share of the underlying assets of the partnership, in part because the buyer would not own the underlying assets and in part because the terms of the partnership agreement burden the assets. Consequently, the fair market value of a partnership interest is almost certain to be less than the proportionate value of the assets of the partnership. And it is the fair market value *of the transferred partnership interest* that is used to determine the amount of tax due as a result of the transfer.

With regard to estate tax cases, the IRS has been successful in its efforts largely in cases where taxpayers have failed to respect the integrity of the entities that they form. In these cases, the Tax Court has applied § 2036(a) to bring the value of the

assets of the partnership back into decedents' estates as retained life interests. Section 2036(a) provides as follows:

> (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 an 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.
>
> I.R.C. § 2036.

This material is intended to assist practitioners in advising their clients at each step of forming, operating, and defending a partnership to avoid pitfalls that the courts and the IRS are pointing to when opining that, in essence, the existence of a partnership should be disregarded for valuation purposes.

## II. CONSIDER APPROPRIATENESS OF PARTNERSHIP

### A. KEEP POTENTIAL FUTURE AUDIENCE IN MIND

Preparing for a potential estate tax examination really begins at the estate planning level. Keep in mind that anything that you write or your client writes (even if protected from discovery by one or more privileges) may later be viewed by the IRS, a judge, or even a jury. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009) ("Guess we have to be real straight on who borrowed what etc. so the partnership looks very legit."), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("[Y]ou have to get the assets into the LLC first so it's the owner of the assets before you start making transfers."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). For instance, in cases where the IRS has asserted that § 2036 applies (and thus the person who formed a partnership has passed away), the only evidence of non-tax reasons for forming the partnership may be contained in privileged documents.

While advisors should not shy away from explaining the tax effects of forming a limited partnership, it is preferable to have such discussions take place in the context of a discussion of the non-tax reasons, as well. The best evidence of a taxpayer's rationale for forming a partnership often comes from the correspondence prepared in connection with the decision to create the entity.

In attempting to establish the non-tax reasons for forming a partnership, it is helpful if the documentation is such that the taxpayer feels comfortable waiving the attorney-client privilege and producing requested communications that would otherwise be protected from discovery under the attorney-client privilege.

## B. CONSIDER WHETHER CLIENTS ARE READY FOR PARTNERSHIP

Family limited partnerships are like blowfish sushi – handled with precision and care, they can be wonderful; handled carelessly, they are downright dangerous. Limited partnerships can be confusing, and, at a minimum, they are complex. Therefore, it is important to evaluate whether the people who are considering forming a limited partnerships are up to the task. Can they get along? Are they willing to abide by the rules? Are they prepared to pay the legal and accounting fees that tend to come along with the entity? These questions and others are important to address in determining whether your clients are ready for a partnership.

## C. EVALUATE POTENTIAL ASSETS

### 1. Maintain Assets Outside of the Partnership

The courts and the IRS have opined that partners should retain enough assets outside of the partnership to support their lifestyles. The IRS has often asserted that a contributing partner's failure to retain sufficient assets outside of a partnership to maintain his or her standard of living is evidence of an implied agreement of that partner to retain rights to the income from the assets contributed to the partnership. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), ***aff'd***, 503 F.3d 955 (9th Cir. 2007); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd,*** 382 F.3d 367(3d Cir. 2004). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions). In combating, for instance, a § 2036 argument, it is helpful to have contemporaneous documentation of the fact that a contributing partner had sufficient cash flow outside of the partnership to support his or her lifestyle without depending on extraordinary distributions from the partnership.

### 2. Refrain from Contributing Personal Use Assets

In determining whether formation of a partnership is appropriate, partners should consider the nature of the assets to be contributed to the

partnership. For instance, the IRS and the courts have, in their consideration of whether a partnership is to be respected, considered as a negative factor the contribution of "personal use" assets to partnerships (in great part because those assets, on contribution to the partnership, become partnership property but may not be treated as such). *See, e.g., Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007); *Estate of Korby v. Comm'r*, 471 F.3d 848 (8th Cir. 2006), *aff'g* 89 T.C.M. (CCH) 1150 (2005); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd* 417 F.3d 468 (5th Cir. 2005); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part,* 293 F.3d 279 (5th Cir. 2002); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000). Such assets include personal residences, vacation homes, and recreational equipment. If the partners feel strongly about contributing such assets to the partnership, care should be taken to minimize the possibility of IRS attack by ensuring that the partnership is compensated for individuals' (including and perhaps most importantly, partners') use of those assets, *i.e.*, rent should be paid to the partnership for use of the partnership's assets. Failure to do so may lead the IRS to assert, for instance, that § 2036 should apply at death, in light of the fact that a contributing partner retained the right to use partnership property without paying for it.

3. Secure Appraisals for Hard-to-Value Assets

In recent cases, the courts have examined the propriety of partners' capital accounts on formation as a factor in whether § 2036 should be applied to various partnership interest transfers. In that regard, advisors should keep the full and adequate consideration element of the exception to § 2036 in mind and ensure that capital accounts of all partners are properly created, credited, and maintained. Consequently, if partners intend to contribute assets to the partnership that are hard to value (*e.g.*, real estate, oil and gas interests, interests in closely held entities), it is advisable to obtain appraisals of the fair market value of those assets so that the calculation of initial ownership interests in the partnership is as accurate as possible. *See generally Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011) (exhibiting value of using two appraisals for hard-to-value assets). It is equally important to follow the appraiser's fair market value calculations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). For instance, obtaining and relying on the reasonable opinion of a professional appraiser can help the client avoid penalties. *See Giustina v. Comm'r*, 101 T.C.M. (CCH) 1676 (2011).

Likewise, if assets subject to debt or non-liquid assets (such as real estate) are to be contributed to the partnership, the partners should make sure to fund the partnership with sufficient cash to support those assets,

such that the partnership can service its debt[3] and pay real estate taxes and other expenses related to its property. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007) (concluding that decedent retained economic benefit of contributed real estate where property continued to secure decedent's debts and rental income was used to pay decedent's expenses). Doing so may help to minimize fuel for an IRS argument that a contributing partner's debt service or payment of maintenance costs related to assets contributed to the partnership evidences an implied agreement under § 2036 of that partner's right to use those partnership assets.

4. Review Transfer Restrictions

Finally, when determining which assets are to be contributed to the partnership, be sure to review any transfer restrictions that might be applicable to those assets. If the documents governing a particular asset do not permit transfer of that asset without, for instance, written authorization of a certain person or entity, try to begin that authorization process sooner rather than later (or to avoid contributing that asset to the partnership, if it is determined that the transfer restrictions are too onerous).

## D. EVALUATE POTENTIAL PARTNERS

First, potential partners should consider with whom they wish to be partners. Family limited partnerships often have long terms of existence. It is a good idea to consider whether partners think that they will be able to work together throughout the term of the partnership. Evidence of discussion of such considerations is helpful in establishing that the terms of the partnership agreement were negotiated, a factor that is considered, for instance, in determining whether the bona fide sale element of the exception to § 2036 is applicable.

On a similar note, participants should consider the health of their proposed partners. The IRS likes to point to "deathbed partnerships" as evidence of its assertion that the only reason for forming the partnership was tax avoidance. If one or more of the potential partners is seriously ill, the partners might reconsider whether to include her. *See, e.g., Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012) (91 years old but in good health); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009) (bad health); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009) (stable health for first contribution; steep decline for second contribution); *Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (stable health); *Estate of Erickson v. Comm'r*, 93 T.C.M (CCH) 1175 (2007) (bad health); *Estate of Rector v. Comm'r*,

[3] Keep in mind, however, that relief of the contributing partner's debt in this regard may require consideration of income tax issues for that partner.

94 T.C.M. (CCH) 567 (2007) (bad health); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006) (bad health); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005) (bad health); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003) (good health). And beware forming a partnership with a person who is not competent to execute the partnership agreement himself; when determining whether partnerships were formed for bona fide, non-tax reasons, the IRS and the courts have taken into account the fact that an agent, rather than the partner, executed the formation documents. *See, e.g., Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part,* 293 F.3d 279 (5th Cir. 2002).

Second, participants should consider whether the partners will be individual family members, trustees of trusts for family members, entities formed by family members (such as a limited liability company), or some combination of any or all of the above.

In choosing partners, the participants should consider who will be able to make meaningful capital contributions to the partnership. *See Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). To the extent possible, it is preferable to have each partner make a meaningful contribution to the partnership so as to establish that a real pooling of assets and services occurred and to avoid the IRS's argument that, for instance, a child's proportionately small contribution had no real impact – that creation of the partnership was a "mere recycling of value," as that term is used in *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002). (Beware, though, the implications of the investment company rules when determining the nature and amount of the assets to be contributed to a partnership. *See, e.g.*, I.R.C. §§ 721, 351, 368; Priv. Ltr. Rul. 200931042.)

Finally, in determining who the partners will be, forming partners should consider what roles each of the partners will play, if any, in partnership management. Do the partners intend to have the parent manage the partnership? Is the partnership to be used as a tool to progressively teach the next generation? Or is management to be passed immediately to the children? A parent's considerations in this regard and a written record of those considerations can play a pivotal role in later establishing the non-tax reasons for which a partnership was formed.

### E. AVOID GIFT PLANNING UNTIL PARTNERSHIP IS UP AND RUNNING

In an ideal world, the entity would be formed, funded, and functioning before discussion of gift planning even began. However, most clients want to understand all of the pros and cons related to formation of an entity, and most estate planners want to explain all of the possibilities at the outset. The likelihood that the concept of gift planning with partnership interests will not even be mentioned until after the entity is up and running is minimal at best.

However, the risk that advisors and clients take when discussing (and perhaps beginning to implement) gift planning at the outset is that the IRS will assert the indirect gift theory – or even the step transaction doctrine.

That said, it is clear that even the courts anticipate that the tax benefits of an entity will be discussed and explored. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012) ("We are particularly struck by the implausibility of petitioner's assertion that tax savings resulting from the family limited partnership were never discussed. . . . We do not find testimony to that effect to be credible and that lack of credibility infects all of the testimony petitioner offered."). As long as the tax savings discussions are had within the context of the non-tax considerations, later gifts (occurring *after* formation and funding) should withstand scrutiny, barring other negative factors.

*Compare Pierre v. Comm'r*, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd,* 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r,* 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), *and Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002), *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, No. C08-0211-JCC, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006), *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

## III. PARTNERSHIP FORMATION

In the IRS's view, and more importantly, that of the courts, it is critical that partners in a partnership respect the entity as an entity (*i.e.*, comply with the terms of the governing partnership agreement, treat assets of the partnership as partnership assets, etc.). If the partners fail to do so, it is highly unlikely that the IRS or a court will. In that regard, it is important to dot all of the Is and cross all of the Ts. Some suggestions follow:

### A. CONSIDER SEPARATE COUNSEL FOR PARTICIPANTS

Although having each partner represented by separate counsel may be expensive, it also goes a long way toward ensuring that the interests of each partner are considered when forming the partnership and that the terms of the partnership agreement will be reviewed by and discussed among the partners at that time. It also serves to evidence the arm's-length nature of the creation of the partnership. *See, e.g., Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Erickson v. Comm'r,* 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r,* 94 T.C. M. (CCH)

567 (2007); *Estate of Rosen v. Comm'r,* 91 T.C.M. (CCH) 1220 (2006); *Estate of Stone v. Comm'r,* 86 T.C.M. (CCH) 551 (2003).

### B. ENGAGE/CONSULT WITH EXPERIENCED ADVISORS

It is important to hire an attorney and an accountant who are experienced in partnership issues to assist in the decision-making processes, and hiring such advisors should happen sooner rather than later. The earlier that experienced advisors are involved, the less likely the partners are to make a misstep in a potential minefield. Beware of simplified "kit" partnerships that do not take into account the partners' individual reasons for and goals in forming the partnership. *See, e.g.*, *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), ***aff'd***, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd,*** 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), ***aff'd in part and rev'd in part***, 293 F.3d 279 (5th Cir. 2002).

### C. DISCUSS PARTNERSHIP TERMS

In establishing that the creation of the partnership is a bona fide sale as that term is used in § 2036, it is important to document any facts evidencing the arm's-length nature of the transaction. Negotiation of the terms of the partnership agreement by the intended partners is precisely the type of evidence that can be used to establish that the bona fide sale element of the § 2036 exception is met, as was the case in *Estate of Stone v. Comm'r*, 86 T.C.M (CCH) 551 (2003). Furthermore, all partners should be included and participate in these negotiations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). Governing agreements generally should not allow senior family members to maintain 100% management control, nor should the sole power to change partnership terms rest in those senior family members, as these provisions could cause the IRS to argue that the right to possess and enjoy the property was retained by the transferor, thus triggering § 2036 inclusion. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

Using a "kit" partnership may play into the hands of the IRS, as such pre-formulated documents rarely leave room for the tailoring that an attorney with experience in family partnerships can provide. *See, e.g., Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd***, 382 F.3d 367 (3rd Cir. 2004); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

Some of the partnership agreement terms that family members might consider important to negotiate and discuss in this regard are:

- Purpose – what are the family-specific reasons that this taxpayer and her family have for forming the partnership?

- Management structure – who will serve as general partner(s)? Will there be a managing partner(s)? Will unanimity be required for management decision-making if more than one person or entity is managing the partnership?

- Management powers – what actions may partnership management take without the approval or input of the other partners?

- Compensation to managers – will the general partners/managing partners be compensated? If so, at what level?

- Investment policy – what will the partnership's investment policy be? *See Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). *But see Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005).

- Books and records – what books and records will the partners be required to keep? Do partners wish to prepare annual financial statements?

- Distribution policy – will the partnership make regular distributions? Will it make distributions sufficient to cover each partner's income tax liability attributable to his partnership interest?

- Transfer restrictions – what transfer restrictions should be included in the partnership agreement? How will those transfer restrictions impact each partner?

- Partnership term – how long should the partnership stay in existence?

- Use of partnership assets – under what terms may a partner or third party rent a partnership asset?

### D. ENCOURAGE PARTNERS TO DISCUSS PURPOSES OF PARTNERSHIP

Some of the partnership purposes that family members might consider important are:

- Joint enterprise for profit; s*ee Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003).

- Centralized management; *see, e.g., Estate of Purdue v. Comm'r*, 110 T.C.M. (CCH) 627 (2015); *Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

- Furtherance of family investment strategies; *see, e.g., Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH)

1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009); *Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009). *But see Estate of Turner v. Comm'r*, 102 T.C.M. 2011, *supp. by* 138 T.C. No. 14 (2012) (management of passive investments not a legitimate non-tax purpose).

- Preservation of the family business*; see Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010).

- Division of control, financial benefits among children; *see, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012)*; Estate of Murphy v. United States,* 104 A.F.T.R.2d 7703 (W.D. Ark. 2009).

- Marriage protection; *see Keller v. United States*, 2009 WL 2601611 (S.D. Tex. August 20, 2009), *aff'd*, 697 F.3d 238 (5th Cir. 2012).

- Bankruptcy protection.

- Creditor protection.

While the sole purpose of the partnership should not be to save on estate taxes or facilitate gift giving, the existence of these motives, in conjunction with valid, non-tax reasons for forming the partnership, should not preclude the application of the bona fide sale exception to § 2036. *See, e.g.*, *Estate of Stone*, 103 T.C.M. (CCH) 1237 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009); *Estate of Murphy v. United States*, 104 A.F.T.R.2d 7703 (W.D. Ark. 2009).

## E. ENSURE AGREEMENT'S SCHEDULES ARE COMPLETE

Most partnership agreements refer to an attachment, schedule, or exhibit that is intended to list all of the assets that the partners agree to contribute to the partnership at formation and the resulting partnership interests to be received by the partners in return. In some states, such attachments are required by statute; and in some of those states, the attachments must also detail the fair market value of the assets to be contributed. In combating IRS arguments that the formalities of a partnership were not respected, it is important that any such attachments to a partnership agreement be complete at the time that the partnership agreement is signed. And in order to best anticipate questions in audit, such attachments should accurately set forth the assets contributed to the partnership, the fair market value of those assets, and the resulting ownership interests of each partner of the partnership.

Sometimes, it is impossible to know the fair market value of contributed assets – and thus the amount of the resulting percentage interests – at the time that the partnership agreement is formed. This situation can occur if, for

instance, there are hard to value assets such as real estate for which an appraisal as of the formation date is being obtained. This can also occur with regard to securities, for which the value cannot be known until the close of business on the day of formation. If necessary, an amendment to the partnership agreement can be executed once accurate fair market values are known.

### F. Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

Creating capital accounts timely is critical in establishing that the transfer of assets in exchange for partnership interests was a transfer for full and adequate consideration, as that term is used in the exception to the application of § 2036, or was not an indirect gift of the assets contributed to the partnership. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016). To avoid IRS attack, each partner's capital account should reflect the value of the assets that he contributed to the partnership and the percentage interest received by the partner in return. Consider creating capital accounts prior to preparation of the entity's first tax return. *See Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("The tax return itself . . . does not constitute contemporaneously prepared evidence as to the sequence of transactions resulting in the capital account balances."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). In order to refute the application of, among other theories, § 2036, the percentage interests received by the partners should be proportionate to the fair market value of the assets that each contributed. *See, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

### G. Prepare Transfer Documents in Advance and File with Relevant State Authorities

As referenced above, in disputing the IRS's assertions that a partnership should not be respected, it is important to establish that the formalities surrounding formation (and operation) of a partnership are respected. One of those formalities is the transferring of assets to the partnership that the partners agreed to contribute when creating the partnership. In that regard, it is most efficient to have the transfer documents ready at the time that the partnership agreement is signed, so that partners can sign all of the relevant documents necessary to form the partnership agreement and transfer title to the assets into the partnership's name all at once. Doing so also ensures that this very important step does not get overlooked. *See Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008) (finding that partnership formalities were disregarded by significant delays in contributing assets to the partnerships); *Estate of Hillgren v. Comm'r*, 87 T.C.M. (CCH) 1008 (2004) (finding that the taxpayer delayed in transferring property to the partnership); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006) (finding that decedent made no contribution to partnership until more than two months after formation).

Typically, a limited partnership is not formed until a certificate of limited partnership or similar document is filed with the relevant state authority (often, the Secretary of State). Be sure to file such required documentation with the state (and obtain any state licenses or registrations) timely. Delays between the date that a partnership agreement is executed and the date that the partnership is actually formed under state law can be problematic when the IRS gets involved. *See, e.g., Estate of Hillgren v. Comm'r,* 87 T.C.M. (CCH) 1008 (2004*); Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), ***aff'd***, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), ***aff'd***, 283 F.3d 1258 (11th Cir. 2002); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

## H. FILE FOR EMPLOYER IDENTIFICATION NUMBER

Likewise, in order to avoid IRS attack, once a partnership is formed, it is important to apply to the IRS for a federal employer identification number ("EIN") as quickly as possible, *e.g.*, as soon as the certificate of limited partnership is filed and returned by the relevant state authority. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd***, 382 F.3d 367 (3rd Cir. 2004). *But see Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009). As with the failure to timely file certificates of limited partnership, the IRS has pointed to delays in obtaining EINs as evidence that partnership formalities were not respected.

## I. ESTABLISH BANK/BROKERAGE ACCOUNTS TIMELY

It is important to set up partnership bank and brokerage accounts and transfer contributed assets to those accounts as soon as possible after formation for two reasons: first, to establish that the partnership entity is being respected by its partners and the partners understand that the partnership's assets are just that – partnership assets; second, to ensure that any income earned on partnership assets is credited to the partnership – not to the contributing partner. Otherwise, the door is left open for the IRS to assert the applicability of § 2036, on the grounds that the contributing partner had an implied agreement to retain the income from the assets contributed to the partnership. *See, e.g., Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd***, 382 F.2d 367 (3rd. Cir. 2004).

## J. ENGAGE PARTNERSHIP ACCOUNTANT

Accounting issues can make or break a court's view of whether to respect the existence of a partnership. In that regard, it is important to hire an experienced partnership accountant who has knowledge of, among others, such partnership issues as capital accounts, the impact of distributions on partners' respective basis in their partnership interests, the impact of additional capital contributions, redemptions, and sales on ownership interests, § 754 elections,

protective claims, audit procedures, etc. *See, e.g., Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), ***rev'd in part and remanded***, 630 F.3d 1211 (9th Cir. 2011).

### K. CONSIDER DEDUCTING PARTNERSHIP SET-UP FEES

The IRS consistently examines the identity of the payor of partnership set-up fees. If a partner has paid the legal and accounting fees related to creation of the entity and has not been repaid by the partnership, the IRS typically asserts that the partnership has not been respected; that, if it were truly a business entity (and not merely an entity created for tax avoidance purposes), the paying partner would have sought reimbursement by the partnership. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011). Keep in mind that a partnership that pays for (or reimburses) set-up fees may, in most cases, deduct those fees for income tax purposes, although, depending on the amount, it may have to do so by way of amortizing them.

### L. IF NECESSARY, AMEND PARTNERSHIP PERCENTAGES AS QUICKLY AS POSSIBLE AFTER FORMATION

In order to minimize IRS attack, if assets were contributed to the partnership but the precise fair market value of some or all of those assets was not known on the date of formation (as is likely to be the case with hard-to-value assets such as real estate or mineral interests), the partnership agreement (or its attachments) should be amended as soon as information on all contributed assets becomes available. If such amendments are not made, the IRS is likely to assert that the capital accounts of the contributing partners are not proportionate to the fair market value of the assets contributed and, as a result, the exception to § 2036 cannot apply.

### M. CONSIDER WHETHER TO ESTABLISH PARTNERSHIP OFFICE

Increasingly, in its attacks on partnerships, the Service has pointed to entities' lack of physical office space, telephone numbers, and phone book listings as evidence of no "business purpose" for the creation of the partnership. While the purported requirement of business purpose is disputed, obtaining a phone number and perhaps even office space could facilitate a partnership's operations.

## IV. PARTNERSHIP MAINTENANCE

### A. FILE ACCURATE RETURNS AND REGISTRATION STATEMENTS FOR EACH YEAR IN EXISTENCE

It seems common sense – a legal entity has been established; thus, at the appropriate time, a tax return for the partnership must be filed, right? But what if the entity is formed on December 27? Should a tax return for those four days be filed? And what if the entity has no income for the first two or three years that it exists (perhaps it holds only cash and non-income producing real estate, or non-dividend paying stock)? What then?

In both examples, it may be tempting to forgo filing a partnership return. However, to minimize avenues of IRS attack, it is advantageous to file, despite the apparent lack of necessity to do so. First, partnerships often rely on the information contained in the partnership return to document partners' capital accounts. If no partnership return is filed in the partnership's first year of existence, it may be difficult to evidence that the capital accounts were properly created, reflecting the proportionate exchange of assets for partnership interests. Second, even if the partnership has no income, the IRS has been known to assert that the failure to file a return reflects the partners' intent in forming the partnership only as a transfer tax device. Consequently, despite the fact that doing so may seem unnecessary, it is advisable to file returns for partnerships consistently from inception.

In addition, it is important to maintain the partnership in good standing with the relevant state authorities. It is not uncommon for IRS litigators, as their first step in reviewing a transfer tax case, to check with the state authorities for all documents on file for the relevant partnership. It is often at this stage that it is first discovered that an entity's good standing has been revoked for the simple failure to send in annual updates or confirmations of the partnership's address. The IRS typically argues that such revocations are indications that the entity is an entity without any purpose other than transfer tax avoidance.

### B. COMPLY WITH TERMS OF PARTNERSHIP AGREEMENT

This suggestion seems only common sense. However, the IRS consistently reviews partnership agreements with a fine-toothed comb. If the partners have not themselves done so, they may have neglected to comply with some of the more straightforward requirements of the partnership agreement. Consider reading the partnership agreement with a fresh eye and making a list of all periodic administrative requirements. For instance, are regular meetings required? If so, in light of the IRS's frequent assertions that partnerships are nothing other than transfer tax avoidance devices, partners might choose to take minutes, even if not required (although continuing to keep in mind the eventual potential audience), to establish the business approach taken by the partnership. *See, e.g., Estate of Purdue v. Comm'r*, 110 T.C.M. (CCH) 627 (2015); *Estate of*

*Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011). Are annual statements (other than returns) required? Are annual distributions required? Are payments on preferred interests required? Is documentation of the partners of the partnership required to be kept in a certain manner? In order to avoid IRS attack, it is important to ensure that partners treat the entity as a business entity and comply with the terms governing that entity. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), ***aff'd***, 503 F.3d 955 (9th Cir. 2007) ("The parties' failure to respect the provisions of the agreement governing their transaction tends to show that the transaction was not entered into in good faith.").

### C. COMPLY WITH LOAN TERMS, IF LOANS ARE MADE

Beware of lending from the partnership to family members. The IRS and the courts have not looked kindly on partnerships where such loans were made, particularly where the terms of the loans were either undocumented or, where documented, were not complied with. *See Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009). According to the IRS, such loans indicate that partners continue to have access to the assets contributed to the partnership. To minimize IRS attacks, any loans made by the partnership should be properly documented and should comply with the terms of the governing partnership agreement. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd***, 382 F.3d 367 (3rd Cir. 2004). Loan terms should be reasonable, and payments should be made timely. In addition, both the partnership and the debtor should comply with the terms of the loans, including foreclosure, if necessary. As noted in various discussions in this chapter, it is important to treat the partnership for what it is – a separate, legal entity.

### D. DISTRIBUTIONS, IF MADE, SHOULD BE PRO RATA

In order to minimize avenues of IRS attack, and assuming that the partnership agreement requires pro rata distributions (as most do), make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent partner), the IRS typically has argued that the partner receiving distributions retained rights to the assets contributed to the partnership such that § 2036 applies. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd***, 431 Fed. Appx. 544 (9th Cir. 2011). If a prohibited non-pro rata distribution has been made, consider making "make-up" distributions to the remaining partners, perhaps with interest at a reasonable rate. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), ***aff'd,*** 382 F.3d 367 (3rd Cir. 2004).

## E. REFRAIN FROM USE OF PARTNERSHIP ASSETS FOR PARTNERS' PERSONAL OBLIGATIONS

Once contributed to the partnership, partnership assets belong to the partnership – not to the contributing partner and not to any of the other partners. As such, partnership assets should not be used for partners' personal expenses, nor should partners personally pay partnership obligations. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd***, 431 Fed. Appx. 544 (9th Cir. 2011). Consequently, in order to avoid IRS scrutiny, it is important that partnership assets be treated as such. Where partners may have used partnership funds to pay for their individual expenses or used partnership real estate without contemporaneously paying fair rental value, the IRS has often asserted the application of § 2036, on the grounds that there was, at a minimum, an implied agreement that the contributing partner retained the right to use the assets contributed. *See Estate of Disbrow v. Comm'r*, 91 T.C.M. (CCH) 794 (2006). *But see Estate of Stewart v. Comm'r*, 92 T.C.M. (CCH) 357 (2006), *vacated and remanded*, 617 F.3d 148 (2d Cir. 2010), (holding § 2036 was not applicable despite decedent remaining in residence when co-occupied by family member who received 49% interest as gift). To this end, it is important for the partners to maintain sufficient assets outside of the partnership to fulfill their personal needs. *See Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012). As discussed above, where § 2036 is held to apply, the existence of the partnership is essentially disregarded, and evidence as to the value of a transferred partnership interest becomes irrelevant, as it is the value of the underlying assets, rather than the partnership interest itself, on which the transfer tax is imposed. *See, e.g., Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009) (payoff of margin debt of founding partner is not personal expense)*; Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); ***Estate of Gore v. Comm'r***, 93 T.C.M. 1436 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), ***aff'd***, 503 F.3d 955 (9th Cir. 2007); ***Estate of Abraham v. Comm'r***, 87 T.C.M. (CCH) 975 (2004), ***aff'd***, 408 F.3d 26 (1st Cir. 2005); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), ***aff'd,*** 417 F.3d 468 (5th Cir. 2005). *But see Estate of Mirowski v. Comm'r*, 95. T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions).

As indicated above, it is important to keep the partnership's assets separate from the partners' assets. This suggestion applies as well at the death of any of the partners. Often, death causes financial hardship, in that a decedent's assets may be frozen for the time between date of death and the date that a personal representative for the estate is appointed and has collected sufficient assets to begin paying the decedent's debts. If expenses of the decedent must be paid in the interim (beware of personal liability of the personal representative), and no one has access to the decedent's assets, the partnership's checking account should not be used to pay those expenses. (In

such cases, despite objections that post-death facts are irrelevant to valuation of the decedent's partnership interests, the IRS has argued that the fact that partnership funds were used to pay a decedent taxpayer's debts is evidence of an implied agreement by the decedent to retain the right to use assets contributed to the partnership, such that § 2036 should apply.) If absolutely necessary, the partnership may wish to make a loan to the estate of the decedent so that the estate's representative can take care of business.

Alternatively, perhaps beneficiaries of the estate or a third-party lending institution could loan funds to the estate. *See, e.g.,* Estate of Purdue v. Comm'r, 110 T.C.M. (CCH) 627 (2015); *Estate of Duncan v. Comm'r*, 102 T.C.M. (CCH) 421 (2011) (upholding deduction of interest on loan taken from family trust to pay Federal estate tax as necessary administrative expense under § 2053); *Keller v. United States*, 104 A.F.T.R.2d 6105 (S.D. Tex. 2009), ***aff'd***, 697 F.3d 238 (5th Cir. 2012); *Estate of Murphy v. United States*, 104 A.F.T.R.2d 7703 (W.D. Ark. 2009); *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988) (upholding loan – and allowing deduction of interest – made to estate by related entity for purpose of paying estate taxes). *But see Estate of Stick v. Comm'r*, 100 T.C.M. (CCH) 194 (2010) (denying interest deduction on loan from decedent's foundation where estate failed to show loan was necessary).

## F. MAINTAIN CURRENT AND ACCURATE BOOKS AND RECORDS

It is important for partners to maintain a partnership's records, as failure to do so may allow the IRS to argue that the partnership was formed solely for tax purposes. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). In addition, keeping good books and records should allow partners to demonstrate that the partnership was operated as the business that it is, formed with valid non-tax reasons in mind.

## G. AVOID MULTIPLE AND IRREGULAR TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIP

When asserting that § 2036 should apply, the IRS looks for any facts that it can find to indicate an implied agreement that a taxpayer retained rights related to assets transferred to a partnership. For example, where a partnership has redeemed numerous partnership interests held by a partner, or made multiple loans, non-regular distributions, or non-pro rata distributions to that partner, the IRS may argue that the facts indicate an implied agreement that the taxpayer retained rights to the assets that he transferred to the partnership, such that § 2036 should apply to, in effect, disregard the existence of the partnership for valuation purposes. *See, e.g., Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016). In order to avoid such arguments by the IRS, numerous transactions of this type between the partnership and its partners should be avoided.

### H. KEEP IN MIND NON-TAX REASONS STATED FOR FORMING PARTNERSHIP

As the partnership grows and the partners develop a working relationship, keep in mind the non-tax reasons that were given for forming the partnership at the outset. *See Estate of Purdue v. Comm'r,* 110 T.C.M. (CCH) 627 (2015); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), ***aff'd,*** 431 Fed. Appx. 544 (9th Cir. 2011). To the extent possible, try to implement them. Doing so can help undercut an IRS attack that the partnership was formed only for tax savings. Rote listing of standard non-tax purposes in the partnership agreement will not necessarily be considered definitive; the partnership agreement should include partnership-specific purposes, and the partnership (and its partners) should implement and fulfill those purposes. *C.f., e.g.*, *Estate of Holliday v. Comm'r*, 111 T.C.M. (CCH) 1235 (2016) (failing to sufficiently identify non-tax reasons); *Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Turner v. Comm'r,* 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

## V. TRANSFERS OF PARTNERSHIP INTERESTS

### A. GENERALLY

When partnership interests are transferred, it is a good time to review the books and records of the partnership to ensure that they are in order. Due diligence at this stage (and at all others) bolsters the defensibility of the partnership – it is a respected, stand-alone entity.

It is also important to consider whether a transfer of a partnership interest triggers any rights of first refusal; if so, it is important in warding off IRS attacks to comply with any such transfer restrictions.

It is helpful at the audit stage in particular if partnership management (and its accountants) have kept careful track of changes in partnership interests (perhaps through keeping a historical spreadsheet outlining each transfer of partnership interests) and to update the partnership books and records to reflect any such changes. Doing so concurrently with transfers assists at the audit level, as such a record provides contemporaneous evidence of the transfers and can, again, bolster the position that the partnership is an entity separate from its partners. If necessary, consider restating the applicable schedule or exhibit to the governing partnership agreement to reflect the change.

Regardless of the nature of the transfer, it is important to document the transfer of partnership interests. In order to minimize IRS attacks, such transfer documents should be executed by transferor and transferee, and the document should be dated on the date that they are signed (though the effective date may be different). *See, e.g., Estate of Lockett v. Comm'r*, 103 T.C.M. (CCH) 1671 (2012); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009*), rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011); *Holman v. Comm'r,* 130 T.C. 170 (2008), ***aff'd,*** 601 F.3d 763 (8th Cir. 2010).

Ensure that the Certificate of Limited Partnership for the partnership is amended, if necessary, and filed with the relevant state authority. Failure to do so may give the IRS room to argue that the entity was not respected by its partners.

Finally, consider whether to make a § 754 election. Many factors should be taken into account when determining whether a § 754 election should be made when an interest in a partnership is transferred (whether by sale or by transfer at death). *Temple v. United States*, 423 F. Supp. 2d 605 (E.D. Tex. 2006) (holding reasonable for partnership and buyer to negotiate § 754 election in acquisition). One such consideration, however, is whether any transfer tax return related to the transfer may be audited by the IRS. If the return is audited, to the extent that it is finally determined that the value of any partnership interest is greater than the value reported on the estate tax return, an election by the partnership under § 754 may be advantageous, as it could apply to cause a step-up in the partnership's inside basis in the decedent's proportionate share of the partnership's assets. Be sure to use the stepped-up basis resulting from a timely made § 754 election. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Thus, any finally determined increase in value of the decedent partner's partnership interest, where such an election has been made, may allow the partnership to seek an income tax refund related to sales of partnership assets since date of death, as any capital gains related to such sales will have been reduced. (Keep in mind that protective claims may need to be filed if the statute of limitations is close to running on the income tax returns but the examination of the transfer tax return has not been completed.)

### B. BY GIFT OR SALE

In addition to the considerations discussed in paragraph A above, when the transfer is to occur by gift, it is important to refrain from gift planning until the partnership is formed and operating in order to avoid (as much as possible) the indirect gift theory discussed above. *Compare Pierre v. Comm'r*, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008)*, aff'd,* 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), and *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002) *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277, 1289-91 (2008) (declining to apply § 2036 even where gift planning occurred simultaneously with entity planning due to fact that (1) taxpayer had sufficient funds outside partnership to pay gift taxes related to gift of partnership interests;

(2) taxpayer's capital account was properly credited with assets contributed; and (3) taxpayer would have been entitled to distribution in accordance with capital account upon dissolution of partnership).

Additionally, gifts of entity interests may not qualify for the gift tax annual exclusion if the present interest test is not satisfied. To satisfy the present interest test, a donee must have a right to either the immediate enjoyment of the property (including the ability to immediately transfer it) OR the immediate enjoyment of the income from the property. *See, e.g., Estate of Wimmer v. Comm'r,* 103 T.C.M. (CCH) 1839 (2012); *Fisher v. United States*, 2010 WL 935491 (S.D. Ind. Mar. 11, 2010); *Price v. Comm'r*, 99 T.C.M. (CCH) 1995 (2010).

When a transfer occurs by sale, be sure to consider the income tax implications of such a transfer.

### C. AT DEATH

When the transfer of partnership interests occurs as a result of a partner's death, it is especially important to review the transfer to determine whether a lapse occurs under Chapter 14 of the Internal Revenue Code and to report the interest transferred accordingly. While many partnership agreements are written with an eye toward avoiding the application of Chapter 14, not all have incorporated this concept.

Further, in order to simplify estate administration and potential audit, consider maintaining the partnership interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS. Once an IRS closing letter is received and the partnership interest is to be transferred into the hands of the appropriate beneficiary, document the transfer from the estate to the beneficiary, and that transfer document should be executed by both the executor and the recipient beneficiary.

### D. BY REDEMPTION

When a partnership interest is transferred by way of redemption from a partner by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Next, be sure to document the redemption, to be executed by partnership management and the transferring partner. Consider having other partners consent, given that a redemption may affect them economically. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. Taking these steps will help avoid IRS attack.

## VI. TRANSFER TAX REPORTING

In order to ensure that any gift, estate, or generation-skipping transfer tax return is prepared in a manner that is most defensible in audit, the taxpayer should engage an experienced attorney or accountant to prepare such return.

### A. OBTAIN APPRAISAL FROM INDEPENDENT, QUALIFIED APPRAISER

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and qualified appraisal of the fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in the area of partnership valuation, and has the appropriate certifications. In addition, attaching an appraisal to a tax return can be a way to satisfy adequate disclosure requirements and to start the running of statutes of limitations. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer. *Knight v. Comm'r*, 115 T.C. 506, 519 (2000).

### B. ENCOURAGE COMMUNICATION AMONG APPRAISER, CLIENT, AND ADVISORS

Strong communication between the client, the client's advisors, and the appraiser should greatly improve the quality (and defensibility) of an appraisal. A high-quality appraisal, which is more often the product of thorough communication, improves the odds that a case involving good legal facts will achieve the best result possible.

### C. CONFIRM WITH THE APPRAISER THE INTEREST TO BE VALUED

Depending on the terms of the partnership agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

### D. CONSIDER WHETHER TO AGGREGATE INTERESTS

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, certain real authority suggests that the interests should be aggregated. If, however, the general partnership interest was held by the decedent, and the limited partnership interest is held in a marital trust created by the decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should *not* be aggregated. *See, e.g., Estate of Bonner v. United States,* 84 F.3d 196 (5th Cir.

1996); *Estate of Bright v. United States,* 658 F.2d 999 (5th Cir. 1981); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999).

### E. CONSIDER WHETHER TIERED DISCOUNTS MIGHT BE APPROPRIATE

Depending on the nature of the asset transferred, two layers of discounts might be merited. *See, e.g.*, *Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497, 1502 n.5 (2008). If the transferred asset is a minority interest in an entity that holds a minority interest in another entity, two sets of discounts could apply to each of the two separate entities. *Id.* (*citing Estate of Piper v. Comm'r*, 72 T.C. 1062, 1085 (1979); *Janda v. Comm'r*, 81 T.C.M. (CCH) 1100 (2001); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680, 1690-91 (2000), *aff'd*, 19 Fed. Appx. 90 (4th Cir. 2001); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320-21 (1974)). However, where the transferred asset constitutes a significant portion of the parent entity's assets or where the transferred asset is the parent entity's "principal operating subsidiary," the Service may argue that only one level of discounts should be applied. *Id.* (*citing Estate of O'Connell v. Comm'r*, 37 T.C.M. (CCH) 822, 825, 833 (1978), *aff'd on this point and rev'd on other grounds*, 640 F.2d 249 (9th Cir. 1981)).

### F. PROMOTE DEFENSIBILITY OF VALUATION REPORTS

A readily defensible partnership valuation report does not arise by happenstance, but rather by the conscientious efforts of the appraiser, advisors, and the client. The more thorough the valuation report, the more defensible it likely will be should a dispute arise. The appraiser should conduct due diligence, discussing with the general partner issues such as the partnership's investment philosophy, asset allocation, and return targets. The appraiser should review and consider the appraisals of the partnership's underlying assets. The valuation report should be supported by empirical data that is clearly understood by the appraiser, such as restricted stock studies and discussion of comparables, and the comparative factors employed should be relevant and useful. The report should fully describe the partnership's assets and financial history. Throughout the valuation report, care must be taken to avoid typos and errors, as they may call into question the competence of the author of the report. Finally, a non-appraiser should be able to understand the analysis and conclusions of a valuation report.

### G. REVIEW APPRAISAL CLOSELY FOR FACTS

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report so that his valuation conclusions are not based on incorrect factual assumptions. It is also helpful to make sure that a copy of the partnership

agreement is included with the final appraisal, perhaps as an exhibit. *See Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006) (declining to rely on IRS appraisal where expert "did not understand Kohler's business").

### H. TRY TO LIVE BY FACTUAL INFORMATION PROVIDED TO APPRAISER

Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. However, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such an occurrence might take place. Living with the factual information provided to the appraiser may help avoid such assertions.

### I. BEWARE OF ROUNDING ON APPRAISALS AND TAX RETURNS

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

### J. UNDERSTAND IRS SETTLEMENT GUIDELINES

In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25. *See, e.g., Lappo v. Comm'r,* 86 T.C.M. (CCH) 333 (2003); *McCord v. Comm'r,* 120 T.C. 358 (2003), *rev'd,* 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r,* 86 T.C.M. (CCH) 412 (2003).

## VII. PREPARING TO RESPOND TO IRS AUDITS

### A. CONSIDER BRINGING IN LITIGATION COUNSEL

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later, even if litigation counsel does not meet with the IRS and only serves as a consultant to the taxpayer. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information, and consideration of the eventual burden of proof under § 7491.

### B. DETERMINE WHETHER A DOCUMENT DESTRUCTION POLICY EXISTS; IF SO, SUSPEND

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of failure to do so may include sanctions against the attorney and the client for spoliation of evidence. *See, e.g*., *Phoenix Four, Inc., v. Strategic Resources Corp*., 2006 WL 1409413 (S.D.N.Y.); *Qualcomm Inc. v. Broadcom Corp.*, No. 05CV1958-B, 2008 WL 66932 (S.D. Cal. Jan. 7, 2008).

### C. IMPLEMENT YOUR OWN "AUDIT"

At this stage (or even before an IRS audit begins), it may be beneficial to your client to review the taxpayer's books and records to determine which issues the IRS may identify as problematic. Test the strengths and weaknesses of the planning, reviewing both the legal authorities (new and old) and any post-planning administration that may impact the analysis of the validity of the plan or entities within the plan.

Assess the strength of the IRS's position. Has the IRS obtained an appraisal? Or is the IRS relying only on an engineer's report? Is the examining agent in a position to review the merits of the case? Does the agent have authority to negotiate settlement? Or will you need to consider requesting a meeting with the agent's supervisor?

### D. CONSIDER THE BURDEN OF PROOF

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the taxpayer lost. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court cannot decide who should win in light of the evidence, the taxpayer will win. Under § 7491, if a taxpayer (who is not a partnership, corporation, or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and, if a court is undecided, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of § 7491.

### E. CONSIDER THE IMPACT OF PRIVILEGES

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as "the privilege"). As a general rule, the privilege covers client communications made to the attorney with the purpose of seeking legal advice. *See Scott v. Beth Israel Medical Center, Inc.*, 847 N.Y.S.2d 436 (N.Y. Sup. 2007) (holding that employer's

e-mail monitoring policy caused e-mails sent to attorney from work to lose attorney-client privilege because they were not confidential, and work product privilege does not apply where careless conduct suggests no concern for protecting privilege). *But see Sims v. Lakeside School*, 2007 WL 2745367 (W.D. Wash.) (holding that web-based e-mails and other materials prepared for communicating with counsel on employer-provided laptop were protected by attorney-client privilege). Keep in mind that the privilege is the client's (rather than the attorney's) to waive.

The work-product doctrine, on the other hand, protects an attorney's thoughts and work *in preparation for litigation*. The work product of an attorney or his or her staff prepared in anticipation of litigation is protected from disclosure. In fact, the attorney work product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. The purpose of the work product doctrine is to encourage lawyers to thoroughly prepare for litigation (even if not yet pending) through investigation of the good and the bad, without fear of being forced to disclose their thoughts and analysis. *See* Fed. R. Civ. P. 26(b)(3). Contrary to common misconception, the work-product doctrine only begins to apply to an attorney's work that is done "in anticipation of litigation." The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent. *See United States v. Adlman*, 68 F.3d 1495 (2d Cir. 1995). According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney's work even during the audit process. *See United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999). Courts have extended work product doctrine protection even to proposed transactions. Recently, one district court found that the work product doctrine applied to tax accrual work papers of a company because the company's counsel believed that certain transactions entered into by the company would eventually be challenged by the IRS. *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007), *aff'd in part, vacated in part, and remanded,* 553 F.3d 87 (1st Cir. 2009).

More recently, the U.S. Congress enacted a new federal privilege under § 7525 – the tax practitioner privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege.[4] *See also Schaeffler v. United States*, 806 F.3d 34 (2nd Cir. 2015). Note, however, that in some jurisdictions, the tax practitioner privilege has been interpreted not to cover advice related to tax return preparation. *See United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

[4] "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." I.R.C. § 7525.

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of § 2036 and/or penalties), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter. *See* FED. R. EVID. 502 (addressing effect of inadvertent waiver as well). Unfortunately, you cannot just pick and choose to waive the privilege with regard to favorable documents.

### F. CONSIDER WHETHER PRODUCTION OF PRIVILEGED INFORMATION MAY HELP YOUR CASE

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner's privilege under § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives such privileges, such that documents and information that would otherwise be protected from discovery are produced. This is particularly true in estate tax cases, where the best person with personal knowledge – the decedent taxpayer – is not available to testify. Beware, though, of subject matter waiver. In essence, you cannot pick and choose what to produce. If the taxpayer waives the privilege as to one document with regard to, for instance, formation purposes, you cannot refrain from producing another document on the same subject that may contain potentially harmful discussion as well.

### G. PROVIDE RESPONSES TO THE IRS THAT ARE TRUE AND CORRECT, TO THE BEST OF THE TAXPAYER'S KNOWLEDGE

The taxpayer's duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer's knowledge. Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership. It is also important to keep in mind that the examiner involved may not have the authority to negotiate a settlement. When determining how much information to reveal voluntarily, the strength of the IRS's position must also be considered.

### H. KEEP IN MIND THAT ANYTHING STATED OR WRITTEN CAN BE TREATED AS AN ADMISSION

It is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer's planning. Anything stated or written to the IRS at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

## I. PRODUCE RESPONSIVE DOCUMENTS IN THE TAXPAYER'S POSSESSION, CUSTODY, OR CONTROL

It is the taxpayer's duty to produce responsive documents in his possession, custody, or control. While documents held by the taxpayer's attorney, accountant, or bank are likely to be construed as within his possession, custody, or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

However, the taxpayer need produce *only* those responsive documents in his possession, custody, or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody, or control that are responsive to the request.

## J. KEEP CAREFUL TRACK OF DOCUMENTS AND ELECTRONIC FILES PRODUCED TO THE IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.

## K. UNDERSTAND THE IRS'S BROAD SUMMONS POWER

The IRS has a very broad power to summons any information, books, and records that it deems necessary to carry out is mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a); *see also, e.g., United States v. Richey*, 632 F.3d 559 (9th Cir. 2011); *Cavallaro v. United States,* 284 F.3d 236 (1st Cir. 2002). As might be expected, however, this broad power is subject to traditional privileges.

## L. FILE PROTECTIVE CLAIMS IF NECESSARY

Keep in mind that sometimes resolutions of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund (Form 843) on the income tax side. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016). If so, you may find it necessary to file protective claims for refund or administrative adjustment requests (AARs) if the partnership is a TEFRA partnership to protect rights to income tax refunds that may

eventually be due. *See* I.R.C. §§ 6031(A), 6222-6231. Keep in mind the Variance Doctrine as you formulate your protective claims.

### M. CONSIDER WHETHER IT IS FEASIBLE TO KEEP PARTNERSHIP IN PLACE

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. Although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might increase the value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), ***aff'd***, 503 F.3d 955 (9th Cir. 2007).

### N. IN THE ESTATE CONTEXT, BEWARE OF DISTRIBUTING ENTITY INTERESTS

Beware of advising your client executor to make distributions of partnership interests from the estate (or other estate assets for that matter) prior to receiving an IRS closing letter. Among other reasons, under I.R.C. § 6324, a special federal estate tax lien immediately attaches to the entire gross estate of a taxpayer at her death. Under 31 U.S.C. § 3713, an executor has personal liability to pay estate taxes to the extent that he has paid any debts of the decedent or made any distributions to beneficiaries of the estate prior to payment in full to the IRS of the estate tax owed. An executor may request a release of personal liability from the IRS under I.R.C. § 2204 upon the payment in full of estate taxes owed.

### O. TREAT INFORMAL INTERVIEWS AS DEPOSITIONS

Although interviews by the IRS can be quite informal, neither the taxpayer nor the advisor should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor's office (that of the attorney or accountant), rather than at the taxpayer's office or home. Consider also having a court reporter present to ensure that the taxpayer's responses are not misconstrued.

### P. UNDERSTANDING THE IRS'S SETTLEMENT GUIDELINES

In early 2007, the IRS issued settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25; *see also, e.g., Lappo v. Comm'r*, T.C. Memo 2003-258; *McCord v. Comm'r*, 120 T.C. 358 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412 (2003).

## VIII. CONCLUSION

In conclusion, many of the suggestions considered here should assist estate planners to fine-tune interactions with clients to ensure that creation of an entity fits with and implements clients' goals – both tax and non-tax in nature. A practical approach that the courts seem to rely on, whether explicit or implicit, is the smell test. Does the transaction "smell bad" or "look bad"? If so, you might re-structure, explore further with the client, or even recommend against a partnership structure to accomplish the client's goals. Use your olfactory senses to assist the client in addressing his needs in the most tax-efficient manner, all the while keeping in mind that anything you say or write may be discoverable (despite the attorney-client privilege). Work with your appraiser to ensure that she has all relevant information, thereby ensuring the most defensible appraisal. When done right, implementation of an entity can accomplish numerous client goals, while at the same time saving taxes. When done wrong, the same structure can save no taxes and cost the client time, money, and emotional drain. To avoid this result, help your clients treat entities as the business structures that they are. And ensure that your appraisers understand the nature of the clients' business and goals.