

TAX NEWS & COMMENT

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IRS MATTERS

2010 ESTATE & GIFT REGS., RULINGS AND PRONOUNCEMENTS OF NOTE

2010 LIKE KIND EXCHANGE DECISIONS & RULINGS

A proposal in "Small Business and Infrastructure Act of 2010: to limit the term of GRATs to 10 years easily passed the House but was not ratified by the Senate. Limiting the term of GRATs to 10 years would greatly reduce their effectiveness in estate planning. However, the bill left intact the viability of "zeroed out" GRATs.

IRC § 67(e) provides that certain administrative expenses incurred by trusts and estates are subject to limitations on deductibility. Costs that would not have been incurred except by reason of the property being held in an estate or trust are exempt from those limitations. Thus, costs
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FROM THE COURTS

2010 Gift & Estate Tax Decisions of Note

In *Estate of Stewart v. Com'r.*, 617 F.3d 148 (2nd Cir. 2010), *rev'g* and *rem'g* T.C. Memo 2006-225, the decedent gifted a 49 percent tenancy in common interest in a Manhattan condominium to her son six months before her death. Both mother and son continued to reside in the residence until the decedent's death. The decedent's estate tax return reported only the (discounted) value of the retained 49 percent interest.

On audit, the IRS contended that the entire condo should have been included under IRC § 2036. Reversing the Tax Court, the 2nd Circuit held that the decedent had not retained beneficial enjoyment of the
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FROM WASHINGTON

2011 FEDERAL & NEW YORK TAX PLANNING & ANALYSIS

The 2010 Tax Relief Act, passed by Congress on December 17, 2010, extended EGTRRA for two years. EGTRRA will now "sunset" on December 31, 2012, with the following implications:

¶ The Bush tax cuts, which impose a maximum income tax rate of 35 percent, will remain in effect until sunset;

¶ Favorable rules for (i) itemized deductions and (ii) the phase out of personal exemptions will remain in effect until sunset;

¶ A maximum income tax rate of 15 percent on capital gains and dividends will continue until sunset;
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Tax Analysis

Litigating in the NYS Division of Tax Appeals

I. Representation

Lincoln's adage that "he who is his own lawyer has a fool for a client" appears particularly apt for those taxpayers who represent themselves in tax disputes, since not only are they often unfamiliar with the procedural aspects of the litigation process, but they are also often unfamiliar with the tax law.

Tax Litigation

Although administrative law judges make every effort to accommodate *pro se* taxpayers, proceedings at the Division of Tax Appeals are
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POST MORTEM ESTATE & INCOME TAX PLANNING

I. Estate Tax Returns

Calculation and remittance of federal and NYS estate tax is of primary concern in administering an estate. An estate tax return must be filed within nine months of the decedent's death, and payment must also accompany the Form 706. IRC § 6075. A request for an automatic six-month extension may be made on Form 4768. Such request must include an estimate of the estate tax liabilities, since an extension of time to file does not extend the time in which the tax must be paid.

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APRIL COMMENT

Succeeding in Exchanges With Related Parties

[Note: Excerpted from *Like Kind Exchanges of Real Estate Under IRC. §1031* (D.L. Silverman, 3rd Ed., 1/11). View treatise at nytaxattorney.com]

I. Overview of Statute

Section 1031(f) was enacted as part of RRA 1989 to eliminate revenue losses associated with "basis shifting" in related party exchanges. Basis shifting occurs when related persons exchange high basis property for low basis property, with the high basis (loss) property being sold thereafter by one of the related persons and gain on the low basis property being deferred. Basis shifting allows the parties to retain de-
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Estate Planning

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¶ An increase in the AMT exemption amount to \$47,450 will occur;

¶ Favorable rules for rollovers to charities from IRAs will continue;

¶ The option to deduct sales tax in lieu of state income tax will remain in effect until sunset; and

¶ Increased estate and gift tax exemptions will be in effect throughout the period until sunset.

For tax years beginning on or after January 1, 2013, new IRC § 1411 imposes an annual 3.8 percent surtax on passive investment income of trusts and estates, which is the lesser of (i) undistributed “net investment income” of the trust or estate and (ii) the amount by which AGI exceeds the highest inflation-adjusted bracket for estates and trusts in 2013, which is expected to be approximately \$12,000. The measure is intended to help finance health care reform.

Congress codified the “Economic Substance Doctrine,” which is a statutory analogue of doctrines developed by the courts to deny tax benefits to transactions having no purpose other than to garner tax benefits. New IRC § 7701(o) passed as part of the Health Care and Education Affordability Act of 2010. The Act provides that in the case of an individual, the provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

IRC § 6662, which imposes a negligence penalty of 20 percent, has been amended to apply to any transaction “lacking economic substance or transactions found to be subject to “related doctrines.” Thus, the judicial doctrines of “substance over form,” “step-transaction,” and “business purpose” may all be within the ambit of IRC § 7701(o). Since the statute references “business” transactions, its effect on estate tax planning may be limited.



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I. Overview of Changes

The estate and gift tax law underwent a dramatic change in 2010. For this reason, no estates of decedents dying in 2010 will be required to file estate tax returns earlier than September 19th, 2011, the date which is nine months after enactment of the bill.

Perhaps the most surprising development was the accord between President Obama and Congress to increase the combined estate tax and gift exemption beginning in 2010 to \$5 million, and to reduce the maximum transfer tax rate to 35 percent. The \$5 million estate tax exemption amount came in at the high end of most expectations. The five-fold increase in the gift tax exemption from, \$1 million to \$5 million, which begins in 2011, was entirely unexpected. These changes reunify the gift and estate taxes, which had been uncoupled for decade. The total amount a taxpayer can gratuitously transfer during his lifetime or bequeath at death is now \$5 million.

Persons who have made full use of the \$1 million gift tax exemption will now find that they can make further gifts of exactly \$4 million without exceeding the \$5 million lifetime gift tax exemption and incurring a gift tax. Of course, following this strategy will mean that none of the \$5 million applicable exclusion amount would remain at death. In that case, anything not qualifying for a marital or charitable deduction will be subject to estate tax.

Some tax practitioners had encouraged clients to make large *taxable* gifts in 2010 (*i.e.*, over \$1 million) with the expectation that the gift tax rate would increase from 35 to 45 percent in 2011. Taxpayers who followed that advice are now reeling from that strategy. Suggestions for remedying the fiasco include executing disclaimers, or arguing that such gifts were made under a “mistake of law.” If all of the requirements for a disclaimer have been satisfied, that strategy may work. However, the argument that the gift was made under a “mistake of law” seems frivolous.

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The Generation Skipping Tax (GST) exemption will increase to \$5 million in 2010, in step with the estate tax exemption, and will be indexed for inflation thereafter. The maximum GST tax rate for 2010 until sunset tracks the maximum gift and estate tax rate of 35 percent. It is unclear whether the estate of a decedent dying in 2010 and which elects to opt out of the estate tax in favor of the carryover basis regime will be allowed any GST exemption.

Another estate tax development will make it easier for couples to make use of their combined lifetime exclusion amounts. A surviving spouse will now be allowed a credit for the unused lifetime exemption of a predeceasing spouse. Although accomplishing this objective has been possible using credit shelter trusts and other devices which "equalize" estates, the new law makes it easier to utilize the combined \$10 million exemption for spouses. Remarriage adds complexity to calculating the unused exemption and produces surprising results.

The use of trusts for purely estate tax purposes may be marginally reduced by reason of the change allowing a credit for the unused exemption of the predeceasing spouse. However, combined estates which exceed \$10 million will continue to find trusts an indispensable part of estate planning for nontax reasons. In addition, generation skipping planning will continue to require trusts. In short, persons with estates large enough to benefit from the combined spousal exemption of \$10 million would same class of planners who would continue to utilize trusts to accomplish their estate planning objectives.

The statute authorizing the combined these higher gift and estate tax exemptions will be repealed by operation of law at midnight on December 31, 2013, unless Congress acts earlier. At that time, the estate and gift tax exemption amount is scheduled to revert to \$1 million. However, the consensus is that the exemption will

either remain at \$5 million or be reduced to no less than \$3.5 million.

A significant minority of persons believe that that estate tax will be eliminated in the next five or ten years. This view has considerable merit. At some point, the increase in the exemption amount combined with the decrease in the estate tax rate will make the transfer tax an unprofitable business for the IRS.

At the same time, New York has given no indication that it intends to reduce or eliminate its estate tax. In fact, were the federal estate tax to be eliminated, New York might find it expedient to raise its estate tax to replenish declining federal revenues. One would certainly not expect the New York estate tax exemption to increase beyond its present \$1 million in the foreseeable future.

II. New York Allows Separate QTIP Election

To prevent chaos arising from the disparity between the federal and New York exemption amounts, the Department of Taxation now judiciously allows a separate QTIP election to be made for New York estate tax purposes. Now, provided the trust qualifies as a QTIP trust, a separate New York QTIP election will result in no tax at the death of the first spouse, but with inclusion of the amount qualifying for the QTIP deduction to be included in the estate of the second spouse.

TSB-M-10(1)M, issued in February, 2010, now provides that a QTIP Election for New York State purposes when no Federal Return is Required. "In certain cases, an estate is required to file a return for New York State estate tax but is not required to file a federal return. This may occur if there is no federal estate tax in effect on the decedent's date of death or if the decedent died while the federal estate tax was in effect but the value of his or her gross estate was too low to require the filing of a federal estate tax return. In either instance, and if applicable, the estate may still elect to take a marital

deduction for Qualified Terminal Interest Property (QTIP) on a pro-forma federal estate tax return that is attached to the New York State estate tax return." For dates of death on or after February 1, 2000, the New York State estate tax conforms to the federal Internal Revenue Code of 1986 (IRC) including all amendments enacted on or before July 22, 1998. Because the IRC in effect on July 22, 1998, permitted a QTIP election to be made for qualifying life estates for a surviving spouse (see IRC § 2056(b)(7)), that election may be made for purposes of a decedent's New York State estate tax return even if a federal return is not required to be filed. If no federal return is required, the election must be made on the pro-forma federal estate tax return attached to the New York State return. As provided in IRC § 2056(b)(7), once made, this election is irrevocable. In addition, the value of the QTIP property for which the election is made must be included in the estate of the surviving spouse. See IRC § 2044 and New York Tax Law § 954.

For example, one can fund a trust with \$5 million to utilize the \$5 million federal exemption, while at the same time make a QTIP election for New York purposes. The result of this would be that the \$5 million would be shielded forever from federal estate tax. For New York purposes, \$1 million would be shielded from New York estate tax on the death of the first spouse, and the Executor would elect for New York purposes only QTIP treatment for \$4 million in the trust.

Even though the trust would operate as a credit shelter trust for federal purposes, the dispositive provisions of the trust would be identical for all purposes: federal unelected QTIP, New York elected QTIP and New York unelected QTIP. The trust would be required to provide that all income would be distributed to the spouse during his or her lifetime, and no other person could receive anything from the trust during the lifetime of the surviving spouse.

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[Note that if New York had not allowed a separate QTIP election, an executor wishing to make full use of the \$5 million federal exemption would have been required to forego the QTIP election entirely. This would create a taxable estate of \$4 million for New York estate tax purposes.]

III. New \$5 Million Lifetime Federal Gift Tax Exemption

The state of flux of the gift tax exemption amount may facilitate some attractive gift-giving options in the next two years. Paradoxically, if the gift tax exemption is reduced to below \$5 million in 2013, gifts of \$5 million made in 2011 or 2012 could incur a future gift tax liability, since the amount of gift sheltered would theoretically be reduced. Such a result is termed a “clawback”.

Such a “clawback” of the gift tax would not seem to offend the Constitution. When faced with due process challenges to retroactive tax legislation, the Supreme Court “repeatedly has upheld” the legislation. *United States v. Carlton*, 512 U.S. 26, 30, 114 S.Ct. 2018, 2021, 129 L.Ed.2d 22 (1994) [other citations omitted]. The standard applied in determining the validity of retroactive tax legislation under the Due Process Clause is whether “retroactive application is so harsh and oppressive as to transgress the constitutional limitation.” *Carlton*, 512 U.S. at 30, 114 S.Ct. at 2022 (quoting *Welch*, 305 U.S. at 147, 59 S.Ct. at 126).

If the gift tax exemption amount is reduced in 2013, and Congress does not impose a clawback, persons making gifts in the next two years will reap a windfall *vis à vis* those not making large gifts in the next two years. However, an *ex post* denial of a previously allowed gift tax exemption seems more objectionable than permitting a disparity among donors of equivalent amounts at different periods, even if such treatment is not unconstitutional. For this reason, tax-

payors who are inclined to be generous, may find their generosity subsidized by the Treasury in the next two years.

Perhaps one of the most significant effects of the increased gift tax exemption amount will be the advent of new planning opportunities for residents of states such as New York, that impose an estate tax but no gift tax. New York imposes an estate tax on taxable estates exceeding \$1 million. While the current federal estate tax exemption amount has climbed to \$5 million, New York has not matched the generosity of Washington.

Interestingly, while the estate tax rate in New York ranges from 10 to 16 percent, once the \$1 million threshold is breached, the marginal rate of estate tax is pegged to the federal estate tax rate during a particular “envelope”. Therefore, a taxable estate only marginally exceeding \$1 million could be subject to an New York estate tax significantly greater than 16 percent.

Although the New York estate exemption amount of \$1 million is paltry in comparison to the federal exemption amount \$5 million, New York does have one thing that Washington does not have: No gift tax.

Since New York has no gift tax, lifetime gifts made by New York residents may be especially attractive in 2011 or 2012. Consider a couple with a combined estate of \$10 million. If no gifts are made, the federal estate tax exemption would shield the all of their combined assets from federal estate tax. However, only \$2 million could be shielded from New York estate tax; one million at the death of either spouse. If each spouse made full use of the \$1 million exclusion, each would have a New York gross estate of \$4 million. If the first spouse left everything to the surviving spouse, the first spouse would have no taxable estate, but the New York taxable estate of the second spouse would be \$9 million (less any amount consumed or gifted).

Contrast this scenario with one in which the parents make gifts of, for

example, \$5 million in the next few years. Assuming the Wills were structured for no tax at the death of the first spouse, this would reduce the New York taxable estate of the surviving spouse to \$4 million. The reduction in New York estate tax would be \$800,000.

Although it true that spouses with an estate of \$10 million would rarely be inclined to give away half of it during their lifetimes, the point is that lifetime advances may drastically reduce New York estate tax liability without any corresponding increase in federal gift or estate tax.

IV. New Planning Opportunities With QTIP Trusts

To qualify as a QTIP trust, the trust by its terms must provide that only the surviving spouse may possess an income interest in the trust during the lifetime of the surviving spouse. This requirement may be unacceptable if the first spouse wants children or grandchildren to benefit from the trust during the lifetime of the surviving spouse.

However, if the decedent is willing to let the children wait until the death of the surviving spouse to inherit the trust, then this estate planning strategy will result in (i) full utilization of the \$5 million federal exemption amount; (ii) full utilization of the \$1 million NYS exemption amount; and (iii) the creation of a \$4 million marital deduction in the estate of the first spouse to die, negating any federal or New York estate tax in the estate of the first spouse.

Of course, except to the extent the \$4 million QTIP trust is depleted during the lifetime of the second spouse, either by gifts or by consumption, the entire remaining amount of the trust will be included in the taxable estate for purposes of computing New York estate tax. However no part of the trust would be included in the estate of the second spouse for federal estate tax purposes.

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V. New Carryover Basis Rules

Special rules apply for purposes of determining basis of assets inherited from decedents dying in 2010. For decedents dying after December 31, 2009, and before January 1, 2011, the basis of property acquired from a decedent is the lesser of (i) the decedent's adjusted basis or (ii) the fair market value of the property at the decedent's death. Interestingly, more estates with highly appreciated assets will be affected by the carryover basis provision in 2010 than would have incurred estate tax with a \$3.5 million applicable exclusion amount.

Special rules define which assets are "owned" by the decedent or "inherited" from the decedent for purposes of allowing the allocation of basis. Some assets which would ordinarily be considered as owned by the decedent will not be so considered for purposes of allocating basis. Similarly, some assets typically considered as being "inherited" from the decedent will not qualify for purposes of basis allocation.

To temper the harshness of the new rule, Congress provided that the executor may allocate up to \$1.3 million to increase the basis of assets passing to any beneficiary. The \$1.3 million adjustment is increased by loss carryovers and unused losses.

In addition, if the decedent leaves a surviving spouse, an additional spousal exemption of \$3 million applies for "qualified spousal property." Qualified spousal property consists of qualifying property bequeathed outright to the surviving spouse, or in a QTIP trust. Since property passing to surviving spouse is also eligible for \$1.3 million basis adjustment, a total of \$4.3 million in basis may be allocated to property passing to surviving spouse, provided at least \$1.3 passes outright or in a QTIP trust.

Nonresident decedents and noncitizens can claim only a \$60,000 basis adjustment and cannot benefit from unused losses or carryover losses.

This adjustment can be claimed for assets passing to anyone. IRC § 1022(a)(2).

The basis allocation provision references the basis of the asset — not its fair market value. Furthermore, not all assets in the decedent's estate will qualify for an allocation of basis. To qualify for the basis increase, the property must have been "acquired from the decedent" and "owned" by him at the time of his death. Property "acquired from a decedent includes property (i) acquired by bequest, devise or inheritance; (ii) acquired by the decedent's estate from the decedent; (iii) transferred to a trust over which the decedent reserved the right to alter, amend or terminate the trust; and (iv) any other property passing by reason of the death of the decedent without consideration (e.g., property held in joint tenancy). IRC § 1022(e).

Property held in joint tenancy will not be qualified for a full basis adjustment. IRC § 1022(d)(1)(A). One-half of property owned jointly with a surviving spouse would be eligible for the basis adjustment. IRC § 1022(d)(1)(B)(i)(i). With respect to property owned jointly with a nonspouse, a basis adjustment will be permissible to the extent consideration was furnished by the decedent. IRC § 1022(d)(1)(B)(i)(II).

In addition, property acquired by the decedent within three years of death for less than adequate and full consideration will not qualify for a basis adjustment, even though such property would be part of the decedent's gross estate under IRC § 2036. IRC § 1022(d)(1)(C)(i). However, property acquired from a spouse for no consideration will qualify, provided the spouse did not acquire the property for less than adequate or full consideration. IRC § 1022(d)(1)(C)(ii).

In apportioning the \$1.3 million or \$3 million basis adjustment, no adjustment will be permitted to be made to certain assets. This is because some property, while satisfying the requirement of having been "acquired from the decedent" for purposes of the estate tax, will not satisfy the require-

ment of having been "owned" by the decedent at his death.

For example, the interest in a QTIP trust owned by a decedent spouse at his or her death will not qualify for any basis allocation, even though the QTIP would have been required to be included in the decedent's estate under IRC §§ 2033 and 2044. Since the QTIP assets are "owned" by the trust rather than the surviving spouse, Congress excluded those assets from assets to which basis could be allocated.

Estates choosing to elect out of the estate tax will be faced with formidable reporting requirements. The Conference Report states that the basis allocation is to be done on an asset-by-asset basis by the Executor (or trustee of a revocable trust).

IRC § 6018 provides for the filing of an information report by the Executor. If the Executor cannot file the return, he should file a description of the property and furnish the name of every person (e.g., trustee or beneficiary) who holds a legal or beneficial interest in the property. Information reporting applies to all property "acquired from a decedent." Information reporting is made on Form 8939, "Allocation of Increase in Basis for Property Acquired From a Decedent."

Two transfers at death must be reported: First, transfers of non-cash assets whose value exceeds \$1.3 million; and second, transfers of appreciated property acquired by the decedent within three years of death not qualifying for the basis adjustment. IRC § 6018(a). Information required to be furnished pursuant to IRC § 6018 includes the following:

- (1) Name and TIN of property recipient;
- (2) An accurate property description;
- (3) The adjusted basis and FMV at time of decedent's death;
- (4) The decedent's holding period for the property;
- (5) Information concerning char-

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acter of potential gain;

(6) The amount of the basis increase allocated to the property; and

(7) Any other information that the regulations may require.

The Executor must also furnish to each property recipient a statement giving similar information. IRC §6018 (e). Failure to report to the IRS non-cash transfers of over \$1.3 million or certain transfers within three years of death could result in the imposition of a penalty of \$10,000 for each failure to report. IRC §6018(b)(2).

Failure to report to beneficiaries with required information may result in a penalty of \$50 for each failure. IRC §6716(b). If the failure to file with the IRS or report to a beneficiary occurred by reason of an intentional disregard of the rule, a penalty equal to five percent of the fair market value of the property will be imposed. IRC §6716(d). However, no penalty will be imposed if there is reasonable cause. IRC §6716(c).

VI. Opting Out of Estate Tax

Realizing the difficulties presented by the new carryover basis rules, Congress provided estate of decedents dying in 2010 may instead pay estate tax. If the estate wishes to be taxed under the estate tax, no election needs to be made. An election is required only if the estate chooses the carryover basis rules. While opting out of the estate tax in favor of the carryover basis rules eliminates federal estate tax, the future income tax cost associated with a beneficiary who later sells property must be considered.

Accordingly, estates of decedents dying in 2010 will be permitted to file a 706 and calculate the federal estate tax liability, or elect out of the estate tax and proceed with a carryover basis. Most taxable estates of \$5 million or less would not elect out of the estate tax, since \$5 million is shielded by the exemption. Estates

larger than \$5 million will need to calculate whether it makes more sense to pay some estate tax and take a stepped up (or down) basis in all estate assets, or to elect out of the estate tax. If an election out of the estate tax is made, not only will appreciated assets will not receive a step up in basis, but depreciated assets will be receive a basis step down to fair market value if the fair market value at the date of the decedent's death is less than the adjusted basis at the date of death. (However, loss carryovers of the decedent will be permitted to augment the \$1.3 million amount of basis that can be allocated to estate assets.)

Consider the estates of two decedents A and B, both dying in 2010, each of whom possessed a gross estate of \$6 million, and neither of whom was married. Both estates are comprised entirely of securities. Estate A has a basis of \$1 million in its securities, and Estate B has a basis of \$6 million in its securities.

If no election out of the estate tax is made, both estates will have a New York taxable estate of \$4 million and a federal taxable estate of \$1 million. At 35 percent, federal estate tax liability for both estates will be \$350,000. The basis of securities owned by Estate of A would be increased to fair market value. The basis of assets of Estate B would need no step up. (For purposes of this analysis, post-death events which might result in the executor choosing an alternate valuation date will be ignored.)

Would either estate fare better under the carryover basis regime? Estate A has a built-in capital gains tax potential of \$555,555, calculated in the following manner:

FMV	\$6 million
Less:	\$1 million basis
Less:	\$1.3 basis allocation
LTCG:	\$3.7 million
Tax Rate IRC:	0.15
Tax Rate NYS:	0.0897*
Tax:	\$886,890

*Built-in capital gains tax for New York must be considered when

the carryover basis is considered, even though the estate will be subject to New York estate tax. Thus, estates of decedents dying in 2010 will find that they are "whipsawed" by New York when it comes to reporting gains on later sales. Even though New York will impose an estate tax, no basis step up will be allowed for New York purposes if the carryover basis rules are elected for federal purposes. Estates of decedents electing out of the federal estate tax will be required to step up (or down) to fair market value the basis of those assets for New York as well. This factor may tip the scales in favor of not electing out of the federal estate tax for some estates in 2010.

In sum, when calculating gain or loss on the sale by beneficiaries of distributed estate assets, the basis determined for federal purposes will always apply, whether or not an election out of the federal estate tax is made. No separate basis records will be required for New York residents. (Interestingly, the rule is contra in California, which does allow a step up in basis where an election is made out of the federal estate tax.)

If beneficiary of Estate A residing in New York sold the securities immediately after inheriting them, a federal and New York capital gains tax liability of \$886,890 would arise. Since \$886,890 is greater than \$350,000, it would clearly make no sense for Estate A to elect out of the federal estate tax if beneficiary of Estate A plans to sell the securities.

Suppose that the sole beneficiary of Estate A is not planning on selling the securities, but instead intends to retain the securities, receive dividends, and eventually bequeath them to his own heirs. In that case, it might make sense for the Executor of Estate A to elect out of the federal estate tax. If the election out were made, \$1.3 million could be allocated to the basis of any of the securities, which would enable beneficiary to cash out that amount of stock in the future without recognizing any gain.

Now turn to Estate B, which is
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comprised of highly appreciated securities. Estate B would clearly benefit from electing out of the federal estate tax. Since no built-in gains exist, no deleterious income tax consequences would materialize in the future. Even if the beneficiary of Estate B were to sell all of the inherited securities the day after receiving them, no capital gains tax liability would accrue. Since electing out of the federal estate tax would occasion no federal estate tax and no federal or New York State income tax in the future, it would clearly be advantageous for Estate B to elect out of the federal estate tax. Of course, Estate B will still have New York estate tax liability, but this liability would be no different than had the executor of Estate B not elected out of the federal estate tax.

Situations become more complicated if the decedent is survived by a spouse, since an additional basis allocation of \$3 million is available for qualified assets passing to that spouse. Situations also become more complicated if historical cost basis data is not obtainable.

Another factor to be considered when deciding whether to elect out of the estate tax is the possibility of IRS estate tax audit. If the estate elects out of the estate tax, any IRS audit would appear to be limited to basis issues. If basis can be determined with reasonable accuracy, the IRS will have few tools with which to pursue an aggressive estate audit.

If the decedent's estate involved planning with family entities and large valuation discounts were taken, electing out of the estate tax may operate to head off the IRS at the pass. Such a maneuver could achieve the objective foreclosing the IRS from challenging valuation discounts, or from asserting that the decedent retained possession or control over gifted assets with the result that those assets should be returned to the decedent's estate under IRC § 2036.

Still another factor militating against electing out of the estate tax is

necessity of determining the decedent's cost basis in estate assets. It may well be the case that the estate may not have available to it any means of reliably obtaining the decedent's basis in stock or securities. If the executor who has elected out of the estate tax is cavalier about making determinations of historical basis, this could result in other unpleasant tax surprises in the future. Most accountants or attorneys will likely be unwilling to sign or assist in preparing returns or statements which contains basis determinations that cannot be documented. Of course, the \$1.3 million can be allocated to those assets for which historical basis cannot be determined.

However, if the decedent's spouse predeceased and the assets were held in joint tenancy with right of survivorship, the basis of the assets for purposes of the carryover basis rules would at least be clear to the extent of the one-half belonging to the predeceasing spouse. Even if no historical basis records existed which documented what price was paid for the asset, under IRC § 2040, the basis of the predeceasing spouse was increased by one-half of the fair market value at the death of the first spouse. This basis, in combination with the \$1.3 million basis permitted to be allocated, might provide sufficient basis such that it might still be attractive for the estate to consider electing out of the estate tax.

All of these factors should be considered when deciding whether to elect out of the estate tax for decedents dying in 2010. In the end, the decision to elect out of the federal estate tax will require consideration of numerous variables and permutations. There will be no difference for New York estate tax purposes whichever route one elects to take for federal purposes, although there will be a difference for New York income tax purposes. For purposes of New York income tax, electing out of the estate tax will result in a lower basis for future sales by beneficiaries.

A federal estate tax return is not required for federal purposes if the

gross estate of a decedent dying in 2010 is less than \$5 million. A federal estate tax return is not required for federal purposes even if the gross estate of a decedent dying in 2010 is greater than \$5 million if the executor elects out of the federal estate tax.

However, New York requires submission of a federal estate tax return for taxable estates over \$1 million. This is true whether or not the federal estate tax return is required to be filed with the IRS. As is the case with income tax returns, New York "piggybacks" off of the federal form 706. New York does have its own ET-706, but this is more or less a vehicle for reporting the summaries obtained from the federal form 706.

Even if the carryover basis regime is selected for a decedent dying in 2010, or even if the federal gross estate is less than \$5 million, the executor of a New York decedent dying in 2010 must still file a completed federal estate tax return, along with ET-706. One would assume that since the federal return is not being filed with the IRS, it would not be necessary to sign the IRS Form 706 included as an attachment to the ET-706. The Form 706 may also contain calculations that are unnecessary for completing the ET-706.

VII. Portability of Spousal Applicable Exclusion Amount

Special rules apply to the issue of "portability," or either spouse being able to utilize the remaining portion of the predeceasing spouse's unused lifetime exclusion. New IRC § 2010 provides that the applicable exclusion amount equals the (1) "basic exclusion amount" plus the (2) "the deceased spousal unused exclusion amount."

The basic exclusion amount is, for 2011 and 2012, \$5 million. If the annual exclusion amount were to decrease, the basic exclusion amount would also decrease. The "deceased spousal unused exclusion amount" is the lesser of (i) the unused portion of the first deceased spouse's unused ex-

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clusion amount and (ii) the basic exclusion amount.

To illustrate, suppose first that Spouse A dies in 2011 and utilizes only \$1 million of that spouse's exclusion amount. Spouse B dies in 2013, at a time when Congress has decreased the exclusion amount to \$3.5 million. In this case, the surviving spouse's "basic exclusion amount" would be \$3.5 million. Although the predeceasing spouse had \$4 million of exclusion in reserve when that spouse died, since the applicable exclusion amount in 2013 was only \$3.5 million, in calculating the exclusion amount of the second spouse, the "basic exclusion amount" would be \$3.5 million. The "deceased spousal unused exclusion amount" would be the lesser of (a) \$4 million or (b) \$3.5 million, or \$3.5 million. Thus, the applicable exclusion amount allowed the surviving spouse would be \$7 million.

For purposes of calculating the second spouse's applicable exclusion amount, IRC § 2010(c)(5)(B) provides that the IRS may examine the predeceasing spouse's return to determine the unused exclusion amount of the first spouse to die. This is true even if the statute of limitations for examining the estate tax return for the first spouse for purposes of that spouse's estate tax, has expired. Therefore, if spouse 2 dies 5 years after spouse 1, the IRS could not audit the return of the first spouse to increase that spouse's estate tax liability, but the IRS could audit the return for purposes of calculating the applicable exclusion amount of the surviving spouse.

Note that only the unused exclusion amount of the last spouse may be used, so that in a second marriage situation, only the unused exclusion amount of the predeceasing second spouse could be used. There is a further limitation: When calculating the unused exclusion amount of the predeceasing spouse, only that portion of the predeceasing spouse's own basic exclusion amount may be used. In other words, the predeceasing spouse's

unused exclusion amount includes none of that spouse's "inherited" unused exclusion.

To illustrate, Tom is married to Mary. Mary dies penniless. Therefore, Tom's exclusion amount is \$10 million. Tom then marries Jane. Tom dies. In calculating Jane's exclusion amount, she may use her own \$5 million exclusion amount, but the deceased spousal unused exclusion amount would be only \$5 million, thereby excluding the portion of the unused applicable exclusion amount that Mary received on the death of Tom.

The concept of portability applies to the gift tax as well. Therefore, if neither spouse had made any taxable gifts during their respective lifetimes, and spouse A died in 2011, the exclusion amount for spouse B would be \$10 million. This raises an interesting question: If spouse B does make that \$10 million gift in 2012, what result if Congress reduces the applicable exclusion amount to \$3.5 million for both gifts and estates? If B dies in 2013, in calculating his estate tax, would the estate of B be required to "give back" \$3 million in previously used exclusion?

On the one hand, it would seem unfair to impose estate tax on the Estate of B when, at the time B made the gifts, they were fully covered by the exclusion amount. On the other hand, the estate of similarly situated decedent C, who had made no lifetime gifts would be allowed only \$7 million exclusion amount. Congress has not addressed the issue.

On balance, although it cannot be denied that the estate of B will have achieved somewhat of a windfall by having made lifetime gifts of \$10 million, it seems fundamentally unfair to retroactively impose a tax on B, whose gifts were made in reliance on the \$10 million gift tax exemption. In the final analysis, it is conceivable that Congress could elect to "recapture" the previously used exemption. Provided the taxpayer (or client) is aware of this potentiality, it would seem prudent to consider making such gifts; especially

so considering the considerable estate tax benefits to be achieved by a New York resident.

Despite the allure and seeming simplicity of the new regime permitting the "unused" exemption amount of the first spouse to be added to the exemption amount of the surviving spouse, persons with estate of this magnitude would be well advised not to forego traditional planning involving credit shelter trusts. The reasons for this are myriad: First, the estate tax is in a state of flux; the portability concept sunsets in 2012. There is no guarantee that Congress will extend the portability concept. Even if it does, the exclusion amount could conceivably be reduced. Another reason for not relying on portability is more technical: If the surviving spouse remarries, that spouse will lose the unused exemption of the first spouse. While the surviving spouse may utilize the unused exemption of the new spouse, the unused exemption of the new spouse may be wholly or partially depleted. By utilizing a credit shelter trust, the estate of the first spouse to die will ensure that the full \$5 million exemption amount is used.

One negative aspect of utilizing a credit shelter trust, rather than relying on the concept of portability, is that a second step up in basis will apply if the \$10 million exclusion is utilized at the death of the second spouse. In contrast, if \$5 million funds a credit shelter trust at the death of the first spouse, then the basis step up for the intervening time, *i.e.*, the time between the death both spouses, with respect to \$5 million of assets, will be lost. Finally, the GST exemption is not portable.

Many nontax reasons counsel testamentary transfers to a credit shelter trust. These include protecting assets from creditors, protecting assets of minors, and protecting assets from the profligacy of spendthrifts. Thus, traditional estate planning involving trusts is not likely to wane in the changing estate tax landscape.

Prior to 2010, property acquired from a decedent generally received a stepped-up basis under IRC § 1014.

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transferred portion. The case creates planning opportunities with gifted tenancy in common interests in the Second Circuit.

The Ninth Circuit, reversing the District Court, recently held that the appraiser's entire work file prepared to substantiate an income tax deduction, was not protected by the work product doctrine. The court remanded the case to the District Court to determine which documents, if any, were protected by the attorney-client privilege. *U.S. v. Richey*, No. 09-35462, (1/21/2011).

In response to an audit, the taxpayer's appraiser asserted the attorney-client privilege and the work product doctrine. The Ninth Circuit rejected the District Court's view that the work product doctrine applied since the work had prepared in anticipation of litigation. Instead, the appeals court found that the work had been prepared for the purpose of providing a valuation required for an appraisal report to be filed with the return. The Ninth Circuit found that since the appraisal had not been prepared for the purpose of determining the value of an easement, and not for the purpose of furnishing legal advice. Therefore, documents that were not "communications" were not protected by the attorney-client privilege.

Documents prepared by accountants and consultants should state that the document was prepared in order to assist in a particular legal matter, and should contain the name of the attorney supervising or requesting the work. A cover letter should also reference the letter of engagement pursuant to which the document was prepared. Letters by clients to attorneys and accountants engaged to assist in legal matters should contain the phrase "we request your legal advice." Responses prepared by attorneys or accountants should reference the client's request, e.g., "In response to your request for legal advice."

Under New York law, absent a contrary expression, a transfer to married spouses employing the language

"to John Doe and Jane Doe, his wife," creates the presumption that a tenancy by the entireties is created. Thus, in *Estate of Goldberg*, T.C. Memo 2010-26, the Tax Court rejected the contention of the estate of the first spouse to die that the first spouse had any interest in the property. Thus, the court found that the entire value of the property was included in the estate of the surviving spouse, and that despite any express language in the deed stating that the property was held as "tenants in common" or as "tenants by the entireties," the statutory presumption of New York law controlled.

The subject of an estate tax discount for built-in-capital gains has been percolating throughout the circuit courts for years, with the taxpayer emerging victorious in most of the cases. The result was no different in *Estate of Jensen*, T.C. Memo 2010-182, where the Tax Court allowed a dollar-for-dollar discount for built-in capital gains. The IRS has argued that the discount should be limited to 25.9 percent of the built-in gains, based upon the discount a "prudent buyer" would consider appropriate. Interestingly, using its own present value approach, the Tax Court arrived at a discount even more favorable to the taxpayer than the taxpayer's expert had propounded. In light of this, the Tax Court accepted the estate's proposed discount.

The Tax Court, in *Ludwick v. Com'r.*, T.C. Memo 2010-14, allowed a 17 percent discount for a tenancy in common interest in real estate. The cost of partition is the usual predominant factor in arriving at a fractionalization discount for real property. However, in *Ludwick*, the Tax Court also considered a discount for lack of marketability caused by the delay a partition sale would occasion.

In *Estate of Black*, 133 T.C. 15, the IRS invoked IRC § 2036 to bring back into the decedent's estate the value of stock contributed to a family partnership. The Tax Court rejected the IRS argument, finding that the transfer of closely held stock to the partnership was made for adequate and full consideration. Even though estate

tax savings may have been a factor in the transfer to the partnership, the court found that legitimate nontax purposes existed for the formation of the partnership.

In *Pierre v. Com'r.*, T.C. Memo 2010-106, the IRS prevailed in interposing the step transaction doctrine to collapse multiple steps into a single transaction, resulting in a significant deficiency. In the first step, the taxpayer formed a single member LLC. Two months later, the taxpayer transferred \$4.25 million of liquid assets to the LLC. The taxpayer then gifted discounted interests in the LLC to two trusts for her children. In the final step, the taxpayer sold discounted interests to the trusts. In finding that no business purpose existed for engaging in four transactions, the Tax Court collapsed the steps into a single transaction involving gifts to the two trusts. In so doing, the claimed discounts were vitiated.

Annual exclusion gifts of \$13,000 are an important aspect of estate planning, as they allow the donor to make substantial gifts without intrusion into the lifetime gift tax exclusion. To qualify as an annual exclusion gift, the gift must be of a present interest. Gifts of partnership interests may create problems, since the donee of such an interest may not be deemed to have a present, unrestricted right to the gifted property. Such a problem arose in *Price v. Com'r.*, T.C. Memo 2010-2, where the Tax Court held that gifts of partnership interests made over six years did not qualify for the annual exclusion, since the donees did not have "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment" of either the property or the income therefrom.

If the donee is required, as a condition to receiving the gift, that he or she pay any gift tax associated with the gift, the gift tax paid by the donee may be deducted from the value of the transferred property to compute the donor's gift tax. A QTIP marital deduction trust requires that all income be paid to the surviving spouse, at least annually. A surviving spouse

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who disclaims all or part of that income interest, is treated as making a gift of the entire interest under IRC § 2519. This deemed gift will result in gift tax liability, which the estate may entitled to recover from the donee, under IRC § 2207A. Under IRC § 2035 (c), the amount of any gift tax “paid . . . by the decedent or his estate” within three years of the decedent’s death is includible in the gross estate of the decedent.

The question in *Estate of Morgens v. Com’r*, 133 T.C. No. 17, involved the meaning of the term “paid by the estate.” The estate argued that since the donee of a net gift is responsible for payment of the gift tax, IRC § 2035, by its literal terms, cannot apply. Despite the tax not having been paid by the decedent or his estate, the Tax Court found that the estate’s right of reimbursement was tantamount to the gift tax having been paid by the estate, and that gift tax paid by the donee is includible in the estate of the surviving spouse IRC § 2035. To hold otherwise, noted a concurring opinion, would “exalt form over substance.”

An estate tax return must generally be filed within nine months of the decedent’s death, and payment must also accompany the return. A request for an extension to file does not negate the requirement that payment be made within nine months. In *Estate of Proske v. Com’r*, 105 AFTR 2d 2010-2613 (D.N.J. 2010), the estate neither filed nor paid within nine months, and failed to request an extension. Forty days after the nine-month period, the estate paid \$1.8 million in estimated taxes and filed a request for extension. The request for an extension was premised on the difficulty in determining the marital deduction. The estate premised its failure to pay on the lack of funds occasioned by the late receipt of insurance proceeds, which were the primary source of funds to pay the estate tax. Granting the estate’s motion for summary judgment, the District Court found that the IRS had abused its discretion in failing to extend the time for filing the estate tax return.

The Court also found persuasive the estate’s argument that since the amount of the marital deduction was not clear, the executor should not be penalized for declining to sign a return required to be executed “under penalties of perjury.” *Note: Although New York State has been aggressive in pursuing tax revenues, requests for abatement of penalties, often premised on similar arguments, are often accepted by the Department of Taxation.*

In *U.S. v. Guyton*, 372 Fed. App’x. 5 (11th Cir. 2010), *aff’g per curiam* 103 A.F.T.R. 2d 2009-2112 (M.D. Fl. 2009), the decedent held real property in joint tenancy with one of his sons, Timothy. The real property had been sold by the decedent in the year of his death at a substantial gain. The proceeds passed by operation of law to the joint tenant, his son Timothy.

The other son, James, Jr., was executor of the estate. James, Jr., filed an income tax return for the year of the decedent’s death, but remitted only a portion of the income taxes. The IRS asserted a deficiency against the estate. James, Jr., argued that since the estate had no control over the sale proceeds, it should not be held liable for the unpaid income tax. However, the Court held that the estate remained liable for the income tax, despite the fact that the asset passed outside of the probate estate. Although the brothers had agreed between themselves concerning the manner in which the income taxes would be paid, since the IRS was not a party to that agreement, it could not be bound. The case has implications where a decedent’s will requires estate taxes to be apportioned among the beneficiaries of probate and nonprobate assets where the executor does not have effective control over the nonprobate assets. This could occur, for example, where a life insurance policy is includible in the decedent’s estate, but is made payable to a person other than the estate.

In *Klauer v. Com’r*, T.C. Memo, 2010-65 (2010), the taxpayer entered into an arrangement whereby sold options to a charitable entity, giving the entity the right to purchase land in three separate installments. Af-

ter the first option was exercised, the parties reduced the amount of the subsequent installments. The taxpayer reported the transactions as bargain sales to charities, and took a deduction. The IRS asserted that under the step transaction doctrine, the sales should be collapsed into a single sale. The Tax Court held for the taxpayer, remarking that the charity was under no “binding obligation” to exercise subsequent options, the options were not “interdependent,” and that since the options were exercisable separately, there had been no predetermined “end result.”

In *Smith v. Com’r*, 364 Fed. App’x.317 (9th Cir. 2009), *aff’g by memo* op T.C. Memo 2007-368, the taxpayer made charitable contributions of interests in limited partnerships. The taxpayer’s CPA determined the valuation discounts. The Ninth Circuit affirmed the decision of the Tax Court to deny the charitable deductions since the taxpayer had not submitted a “qualified appraisal” with the return, nor had the taxpayer obtained the required “contemporaneous acknowledgment” from the donee or attached a viable “appraisal summary” with the return. The Court noted that the CPA who determined the valuation discounts lacked valuation expertise, and had prepared a report which was deficient.

Similarly, in *Lord v. Com’r*, T.C. Memo 2010-196, the Tax Court denied the taxpayer’s charitable deduction for an easement, since the appraisal did not satisfy the requirements for a qualified appraisal under Treas. Reg. § 1.170A-13(c). The appraisal submitted had an “effective date” and an “appraisal date” that were a few days apart. The Tax Court stated that to comply with the requirements of a qualified appraisal, the appraisal must state the date of the contribution, the fair market value of the contributed property on that date, and the date the appraisal was performed. The Court found the doctrine of “substantial compliance” to be inapplicable.

The Section 121 exclusion from gain applicable to the sale of residences has raised numerous questions,

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such as those incurred by an estate or trust in connection with the filing of tax returns would be exempt from the limitation, while other costs, such as those incurred in connection with the management of property or investment decisions, would be subject to the two percent limitation. Proposed regulations require the fiduciary to bifurcate fiduciary commissions subject to the 2 percent limitation from fees not subject to the limitation. Notice 2010-32 provides relief from this proposed bifurcation.

IRC § 2053 allows a deduction from the value of the gross estate for claims against the estate. Final regulations issued by Treasury limit estate tax deductions for unpaid claims and expenses. With respect to decedents dying on or after October 20, 2009, an estate may, in general, deduct an expenditure only if the claim or debt is actually paid. However, up to \$500,000 in unpaid claims (not expenses) may be deducted under certain conditions.

The failure to carefully parse the regulations and claim an impermissible expense could result in the IRS imposing a negligence penalty or even a preparer penalty. If a deduction for a claim or expense is taken in an ambiguous situation, the estate should consider making a disclosure on Form 8275R to avoid the imposition of a penalty.

Under Reg. § 20.2053-1(b)(2), only a bona fide claim or expense may be deducted. No deductions may be taken for amounts paid for claims if the transfer is “essentially donative in character.” Amounts paid to family members, beneficiaries and related entities are rebuttably presumed to lack legitimacy.

Under the new regulations, the amount of claim or expense may be determined by (i) court decree; (ii) consent decree; or (iii) settlement.

With respect to amounts paid pursuant a court decree after review, such as those incurred for funeral and administration expenses, are deductible. However, a court order allowing

an expense issued without reviewing the merits of the claim will not establish deductibility under IRC § 2053, and could presumably even result in the imposition of penalties if the order is unreasonable.

A settlement of a claim will result in a deductible expense provided the interests of the parties involved are adverse. The regulations provide that unenforceable, contested, or contingent claims cannot be deducted.

In the event a portion of the payment made for a claim which was deducted is later refunded, the deduction will be reduced and additional estate tax imposed, provided the statute of limitations for assessment has not run. However, it is not clear that the executor has an obligation to contact the IRS with such information.

Several exceptions exist to the “actual payment” rule:

¶ Although in general a deduction may not be claimed to the extent a claim or expense is or could be reimbursed by insurance, such a claim may still be deductible if the executor provides a “reasonable explanation” of why the burden of collection outweighs the anticipated benefits of collection.

¶ A claim or expense may be deducted if the amount to be paid is ascertainable with “reasonable certainty and will be paid.”

¶ The aggregate value of otherwise deductible claims (not expenses) not exceeding \$500,000 may be deducted provided the amount of the claim is determined by a “qualified appraisal” as defined in IRC § 170.

¶ Contingent claims that are almost certain to be paid may be deducted. However, the deductible amount may be reduced to reflect a contingency affecting the ultimate amount of payment.

If a claim or expense cannot be deducted at the time of filing the estate tax return by reason of its not having been paid, but may later become deductible following payment, a “protective” claim for refund may be filed before the expiration of the period for claiming a refund under IRC § 6511. The protective claim must de-

scribe the reason for a delay in the actual payment of the claim or expense. However, the protective claim is not required to specify the amount. The protective claim may be made directly on the Form 706 estate tax return; a separate refund claim form is not required.

Notice 2009-84 provides that the IRS will not generally seek to offset a claim for refund with an offsetting claim relating to an underpayment of estate tax.

Final regulations under IRC § 2053 allow deductions only for claims paid or ascertainable with reasonable certainty and that are bona fide in nature. Such claims would include court decisions, consent decrees. If the nature of a claim cannot be determined prior to the expiration of the statute of limitations for the estate tax, a protective claim may be filed. Claims that are “bona fide” include those occurring in the ordinary course of a trade or business, and those in which the claim is not predicated on an expectation of an inheritance. Treas. Reg. § 20.2053-1(b)(2)(ii).

Uncertainty in gift tax reporting and valuation can significantly impair estate planning. Previously, the IRS had maintained that gifts could be revalued at death for estate tax purposes. However, IRC § 2001(f) now provides that gifts adequately disclosed on a gift tax return cannot be revalued at death. IRC § 7477 and regulations promulgated thereunder now permit the Tax Court to review IRS determinations of the value of gifts. The mechanism for such review entails the taxpayer filing a Tax Court petition in response to an IRS “notice of determination of value”.

Under IRC § 2032, an executor may elect on the estate tax return not to value the gross estate at the date of death. Rather, if the election is made, the fair market value for estate tax purposes with respect to property sold or distributed within six months of the decedent’s death is valued as of the date of sale or distribution. Property sold more than six months after the date of death are valued as of the date

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six months after the decedent's death. If assets have declined in value after the decedent's death, the election may be desirable.

IRC § 2032(d) provides that the election is irrevocable, and that no election may be made if the return is filed more than one year after the time prescribed by law (including extensions) for filing the estate tax return. In PLR 201033023, the IRS denied relief where the estate tax return was timely filed, but the request for relief occurred 18 months after the due date (including extensions) of the estate tax return.

In the facts of CCA 201033030, the taxpayer had filed gift tax returns for previous years, but had failed to correctly report gift taxes. At the decedent's death, and by reason of the taxpayer's error, the IRS found that "adjusted taxable gifts" on the estate tax return should have been increased. This increase would increase the amount of estate tax owed. The issue before IRS counsel was whether the IRS could employ the doctrine of equitable recoupment in Tax Court to collect the gift tax that had never been paid. The advisory concluded that the IRS could equitably recoup the gift taxes, since the three-year period for assessing a deficiency with respect to the gift tax had expired. The doctrine of equitable recoupment is reserved for those situations where the taxpayer has requested a refund, and the doctrine is employed to deny that refund. The doctrine cannot be used to seek payment for gift taxes not paid, since this would impermissibly vitiate the three-year period of limitations in which the IRS may assess a deficiency.

An election may be made under IRC § 6166 to pay estate taxes in installments. PLR 201015003 stated that no election could be made where the estate tax return had not been filed for six years. No negligence penalty was imposed for late payment, since under *U.S. v. Boyle*, 469 U.S. 241 (1985), even though reliance on an attorney or tax professional to actually file a re-

turn does not constitute reasonable cause, reliance on the *judgment* of an attorney or tax professional concerning when the return must be filed does constitute reasonable cause. The IRS could not grant administrative relief, since the IRC § 6166(d) by its terms required the estate to make the election by the due date of the estate tax return.

* * *

2010 LIKE KIND EXCHANGE DECISIONS AND RULINGS OF NOTE

I. Use of Replacement Property as Personal Residence Negates Like Kind Exchange Treatment

Finding that the "use of property solely as a personal residence is antithetical to its being held for investment," the Tax Court, citing objective factors indicating that the taxpayer had little if any actual intention to hold replacement property for productive use in a trade or business or for investment, but rather intended to live in the property, denied exchange treatment. *Goolsby v. CIR*, T.C. Memo 2010-64.

The taxpayer's attempt to rent the replacement property was "minimal" and amounted to nothing more than an advertisement in a local newspaper for a few months. The taxpayer moved into the acquired property "within 2 months after they acquired it," and prior to the exchange discussed with the QI the feasibility of moving into the property if renters could not be found. Moreover, the taxpayer "failed to research rental opportunities" in Pebble Beach and "failed to research whether the covenants of the homeowners association would allow for the rental of the Pebble Beach property." The Tax Court also upheld accuracy-related penalties imposed by the IRS pursuant to IRC § 6662.

II. Properties May be of "Like Kind" Without Being of "Like Class"

In PLR 200912004, taxpayer

operated a leasing business, in which the taxpayer purchased and sold vehicles as the leases terminated. The taxpayer implemented a like kind exchange program pursuant to which the taxpayer exchanged vehicles through a qualified intermediary under a master exchange agreement. The taxpayer proposed to combine into single exchange groups all of its cars, light-duty trucks and vehicles that share characteristics of both cars and light duty trucks, arguing that all such vehicles are of like kind under Section 1031. Ruling favorably, the IRS noted that although the taxpayer's cars and light duty trucks are not of like class, Treas. Regs. § 1.1031(a)-2(a) provides that an exchange of properties that are not of like class may qualify for non-recognition under Section 1031 if they are of like kind. Moreover, Treas. Regs. § 1.1031(a)(2)(a) provides that "in determining whether exchange properties are [of] a like kind no inference is to be drawn from the fact that the properties are not of a like class." Thus, properties can be in different asset classes and still be of like kind.

III. Volatile Organic Compound Credits and Nitrogen Oxide Credits are of Like Kind

PLR 201024036 stated that Parent may exchange NOx Credits (achieved by installing air emission reduction equipment) obtained from subsidiary for VOC credits which it will need to offset its anticipated emissions of Volatile Organic Compounds. The Ruling noted that Rev. Proc. 92-91, Q & A 5 states that emission allowances may qualify as like-kind property for purposes of IRC § 1031. NOx Credits and VOC Credits are of the same "nature and character" since both are "part of [the government's] program to control air pollution." The Ruling then noted that although Nitrogen Oxide and Volatile Organic Compounds are "different chemical compounds" both are used to control nitrogen emissions. Therefore, the differences between the two compounds

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should be considered as differences in “grade or quality,” rather than “nature or character,” and are therefore of like kind.

IV. Ninth Circuit Upholds Tax Court Decision in *Teruya*

Teruya Brothers Ltd. v. Com’r, 124 T.C. No. 4 (2005) illustrates the danger of using a QI where the related party rules could apply. *Teruya*, in a series of transactions, transferred several properties to a QI, who sold them to unrelated parties. The QI used the proceeds to purchase replacement properties from a corporation related to the taxpayer. The Tax Court held that the transaction constituted a taxable sale rather than a deferred exchange, since it had been structured to avoid the purpose of Section 1031(f). Although the corporation recognized more gain on its sale than the taxpayer deferred, it had large net operating losses (NOL) which offset its gain. The court rejected the argument that the non-tax-avoidance exception of Section 1031(f)(2)(C) applied.

The Ninth Circuit in late 2010 upheld the Tax Court’s decision in *Teruya*. The Court of Appeals found that *Teruya* had “decreased their investment in real property by approximately \$13.4 million, and increased their cash position by the same amount. Therefore, *Teruya* had effectively “cashed out” of its investment. Noting that *Teruya* could have achieved the same property disposition through “far simpler means,” the court observed that the transactions “took their peculiar structure for no purpose except to avoid § 1031(f). The presence of the QI, which ensured that *Teruya* was “technically exchanging properties with the qualified intermediary . . . served no purpose besides rendering simple – but tax disadvantageous – transactions more complex in order to avoid § 1031(f)’s restrictions. The exception found in § 1031(f)(2)(C) was inapplicable since “the improper avoidance of federal income tax was one of the principal purposes

behind these exchanges.” (No. 05-73779; 9/8/09).

V. Eleventh Circuit Affirms *Ocmulgee Fields*

In *Ocmulgee Fields*, the taxpayer transferred appreciated property to a qualified intermediary under an exchange agreement, whereupon the QI sold the same property to an unrelated party and used the sale proceeds to purchase like kind property from a related person that was transferred back to the taxpayer to complete the exchange. The IRS assessed a deficiency, arguing that the exchange was part of a series of transactions designed to avoid § 1031(f) and that the taxpayer had not established the “lack of tax avoidance” exception under § 1031(f)(2)(C). Citing *Teruya Bros., Ltd.*, the Tax Court agreed with the IRS, noting that the immediate tax consequences resulting from the exchange would have reduced taxable gain by \$1.8 million, and would have resulted in the substitution of a 15 percent tax rate for a 34 percent tax rate. The Tax Court came close to holding that basis shifting virtually precludes, as a matter of law, the absence of a principal purpose of tax avoidance.

The Eleventh Circuit in 2010 affirmed the Tax Court, concluding that “the substantive result of *Ocmulgee Fields*’ series of transactions supports an inference that *Ocmulgee Fields* structured its transactions to avoid the purposes of § 1031(f). . . .” The court reasoned that even if *Ocmulgee* had not interposed a qualified intermediary, the transaction would fail because it could not establish the “lack of tax avoidance” exception in § 1031(f)(2)(C). The court found no “persuasive justification” for the complexity of its transaction other than one of “tax avoidance.” Although *Ocmulgee* argued on appeal that tax avoidance was not a “principal purpose” of the exchange, the court found that the basis-shifting, reduction in immediate taxes, and shifting of the tax burden to the party with the lowest tax rate all justified negative “inferences”

against the taxpayer. Finally, although *Ocmulgee* argued that it had a legitimate business purpose for the exchange, it failed to establish clear error. Moreover, the “mere existence of legitimate business purposes does not preclude a finding that *Ocmulgee Fields*’ principal purpose for the exchange was tax avoidance.” *Ocmulgee Fields, Inc., v. CIR*, No. 09-13395 (2010). *After the Eleventh Circuit decision in Ocmulgee, and the Ninth Circuit decision in Teruya, it may be difficult to find a more likely than not basis to proceed with an exchange involving a related party in instances where the related party already owned the replacement property.*

VI. Other Related Party Rulings

In CCM 20103038, the taxpayer, an auto dealer, attempted to structure a like kind exchange between itself and dealer, who were related parties under IRC § 267. Citing *Teruya Brothers*, *Ocmulgee Fields*, and Rev. Rul. 2002-83, IRS counsel concluded that the taxpayer “structured its transaction to achieve the impermissible result that Congress addressed in the legislative history.” It then concluded that the “no tax avoidance” exception of IRC § 1031(f)(2)(C) was inapplicable, since qualification under the exception requires that tax avoidance not be “one” of its principal purposes. Therefore, even if other, non-tax avoidance purposes existed, the existence of any tax avoidance purpose would result in the inapplicability of the exclusion. The advisory concluded that “[a]s a matter of interpretation, the Service has consistently limited the § 1031(f)(2)(C) exception to the situations Congress so specifically described in the legislative history. See Rev. Rul. 2002-83. We are not willing to expand the exception to cover the Taxpayer’s situation.”

PLR 201027036 involved an exchange among a group of companies with a common parent. The ruling blessed the transaction. No direct exchange between the parties occurred

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by reason of the interposition of a qualified intermediary. Therefore, IRC § 1031(f)(1) was by its terms inapplicable. In addition, the Ruling concluded that IRC § 1031(f)(4) was inapplicable since the related parties did not exchange high basis property for low basis property. Therefore, no “cashing out” occurred.

VII. Qualified Trust Account and Qualified Intermediary Safe Harbors May Both be Used in Single Exchange

PLR 201030020 corroborated the prevailing view that if all of the safe harbor requirements are satisfied for two safe harbors, both may be utilized in a single exchange. To provide an additional measure of safety to customer's exchange funds, bank proposed to hold exchange funds in a qualified trust account pursuant to § 1.1031(k)-1(g)(3)(iii). Bank also proposed serving as a qualified intermediary pursuant to Regs. § 1.1031(k)-1(g)(4). The ruling concluded that “[t]he fact that Applicant serves in both capacities in the same transaction is not a disqualification of either safe harbor and will not make Applicant a disqualified person.” The Ruling also stated that the bank will not be a “disqualified person” with respect to a customer merely because an entity in the same controlled group performs trustee services for the customer. Finally, the Ruling concluded that a bank merger during the pendency of the exchange would not disqualify it as qualified intermediary for the exchange.

VIII. Rev. Proc. 2010-14 Approves Installment Method Reporting in Failed Exchanges

Revenue Procedure 2010-14 provides guidance concerning a failed exchange caused by the collapse or bankruptcy of a qualified intermediary. In this situation, the taxpayer will be unable to access the funds received

by the QI from the relinquished property sale during the pendency of bankruptcy or receivership proceedings. While Rev. Proc. 2010-14 does not rehabilitate the failed exchange, it recognizes that the taxpayer “should not be required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property.” Accordingly, the taxpayer is put on the installment method of reporting gain, and “need recognize gain on the disposition of the relinquished property only as required under the safe harbor gross profit ratio method.”

IX. CCA 201025049 Addresses “Stock in Trade” Exclusion of § 1031(a)(2)(A)

“Stock in Trade” refers to property that would be included in inventory. Property held “primarily for sale” cuts a wider swath than property excluded from capital gain treatment under Section 1221(a)(1), which excludes only “property held for sale to customers in the ordinary course of trade or business.” This difference is significant. Some property that would generate capital gain if sold will not qualify for exchange treatment. The sale of a vacant lot purchased for investment would qualify for capital gain treatment if sold, and would qualify for exchange treatment if exchanged for other real estate. However, if the lot had been purchased with the intention of reselling it at a profit, while a sale would still generate capital gain (unless the taxpayer were a dealer), the transaction would not qualify for exchange treatment. Since the exclusion applies to both relinquished and replacement property (*i.e.*, “this subsection shall not apply to any exchange of”) neither the relinquished property nor the replacement property may be held “primarily for sale.” Both must be held for productive use in a trade or business, or for investment.

CCA 201025049 interpreted the phrase “stock in trade or property held primarily for sale”. If an asset can

function both as merchandise held for sale and as an asset used in a trade or business, the taxpayer's *primary purpose* for holding the asset determines whether that asset is stock in trade. Temporarily withdrawing an asset from inventory for business use is not sufficient to imbue the property with the attribute of being used in the ordinary course of business operations. The advisory concluded that (i) since the corporation did not possess a “general or indefinite commitment” to use the equipment in its trade or business, the property is not depreciable under IRC § 167 and (ii) since the corporation held the equipment primarily for sale, the exchange will not qualify under IRC § 1031.

* * *

A. New York's Voluntary Compliance Program

New York instituted a “Voluntary Disclosure and Compliance Program” which provides nonfilers with the opportunity to file delinquent returns without incurring penalties and without being subject to criminal prosecution. To be eligible, the taxpayer must not currently be under audit or criminal investigation, and must not have received a tax notice. If the (on line) application is accepted, the taxpayer will be required to file all past due tax returns and pay all tax owed. The taxpayer must also pledge to file future returns. If the taxpayer later reneges, acceptance into the program is “revoked.” A significant benefit of acceptance in the program is that no failure-to-file or failure-to-pay penalties will be assessed; the taxpayer will be responsible only for tax and interest. In addition, the taxpayer will receive immunity from prosecution by the Department of Taxation and all agencies and district attorneys in the state for any tax crimes related to the nonfiling. The taxpayer may also request a “limited look-back period.” This feature limits the number of years

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in which the taxpayer is required to file past due returns. If this request is accepted, tax liabilities in years preceding the look back period will be forgiven. However, the guarantee of no criminal prosecution will extend only to the Department itself; the taxpayer will receive no immunity from prosecution by other agencies or district attorneys in New York.

NYS TAX LITIGATION, CONT.

(Continued from page 1)

governed by the Tax Law and the CPLR. *Pro se* taxpayers with little knowledge in these statutory areas generally fare poorly, frequently making arguments that have been rejected countless times in the past by other taxpayers. In addition, they often create a hearing record so decidedly adverse that a later appeal to the Tax Appeals Tribunal becomes extraordinarily difficult.

The Department of Taxation, on the other hand, is represented by skillful and experienced lawyers who are conversant with the cases and with the system. The Department's counsel are also adept at defusing the actions of auditors who have deviated from established audit procedures during the audit.

Taxpayers not representing themselves at the Division of Tax Appeals or the Tax Appeals Tribunal may be represented by an accountant or by an attorney. Taxpayers appealing an adverse decision of the Tax Appeals Tribunal via an Article 78 proceeding to the Appellate Division may only be represented by an attorney.

II. Conciliation Conference

A taxpayer who disagrees with audit finding will be given the opportunity to participate in a mediation conference with the auditor. This conference is held under the auspices of the Bureau of Mediation and Conciliation Services (BCMS), which is a separate operating bureau within the Department of Taxation reporting directly to the Commissioner of Taxation and Finance.

The goal of the Conciliation Conference is to resolve tax disputes without the necessity of a formal hearing before the Division of Tax Appeals. A request for a Conciliation Conference must generally be made within 90 days after the issuance of a Notice of Determination. The taxpayer who deems the Conciliation Order issued by the Conferee following the Conference unacceptable, may request a formal hearing before the Division

of Tax Appeals within 90 days after the Conciliation Order is issued.

A taxpayer who wishes to bypass the Conciliation Conference may do so by filing a request for a formal hearing before the Division of Tax Appeals within 90 days after the issuance of a Notice of Determination. These time periods are jurisdictional; a taxpayer who fails to timely file a request for a hearing before the Division of Tax Appeals will lose all appeal rights in the administrative tax tribunals. (Relief may still be sought in some cases by bring a declaratory judgment action in state supreme court challenging the constitutionality or the applicability of the statute or assessment. However, this path is perilous at best.)

III. The Division of Tax Appeals

The Division of Tax Appeals, in contrast to BCMS, is an autonomous unit of the Department of Taxation and is independent of the Commissioner of Taxation and Finance. The Administrative Law Judges who preside over hearings at the Division of Tax Appeals are experienced and impartial. Still, the Department of Taxation has an advantage in the Division of Tax Appeals, since tax laws are construed narrowly and in favor of the government. Hearings are held at the offices of the Division of Tax Appeals, located at 500 Federal Street, in Troy. The majority disputes with the Department of Taxation heard today involve sales tax.

Decisions of the Tax Appeals Tribunal, the Appellate Division, Court of Appeals, or United States district or appeals courts sitting in New York may be cited as authority for the taxpayer's case. However, the doctrine of *stare decisis* has no application to cases decided by Administrative Law Judges. Accordingly, those determinations have no precedential value and may not be cited as authority in any brief.

In the 2009-2010 fiscal year, Administrative Law Judges sustained 80.2 percent of the deficiencies or

other action asserted by the Department of Taxation; they cancelled 9.4 percent of the deficiencies or other action; and they modified 10.4 percent of the deficiencies or other action. *New York State Division of Tax Appeals, Annual Report Fiscal Year 2009-2010*.

IV. Analyzing a Sales Tax Case

In fiscal year 2009, sales tax cases represented 59 percent of the cases heard in the Division of Tax Appeals. This is not surprising. With the lure of interest, penalties, and large revenues upon which the sales tax is based, the Department of Taxation aggressively pursues sales tax revenue through audit.

To emerge victorious in a sales tax dispute, the taxpayer should be conversant with some important principles involving sales tax litigation. First, auditors often attack the adequacy of the taxpayer's books and records. Should the Division find these records inadequate, it may resort to "external indices," one of which is a "test period" audit, in which an extrapolation could be made over a lengthy term. Since penalties will also be extrapolated, this is a dangerous position for the taxpayer to be in.

The first question is whether the Division was justified in resorting to external indices. The Division must make an explicit request for books and records for the entire audit period. If only a "weak and casual" request is made for records (*Matter of Christ Cella*, 477 NYS2d 858), the taxpayer may be excused from having failed to provide records. If the auditor failed to conduct a sufficient examination of the records, the use of a test period audit has been held improper.

Does the audit report actually document a finding of inadequacy of records? *Matter of King Crab*, 522 N.Y.S.2d 978. If not, the Division may be unable to establish inadequacy of records. Resort to a test period audit is not justified unless it is "virtually impossible" to determine tax based upon available records. *Matter of Chartair*,

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411 NYS2d 41. Did the auditors fail to review books and records because they were “too voluminous”? *Matter of Names in the News*, 429 NYS2d 755. The Division may not employ an “economic feasibility” test in resorting to a test period audit. The taxpayer has a right to a detailed audit under Tax Law §1138. *Matter of Chartair*, *supra*.

Did the taxpayer or his representative actually consent to a test period audit? Merely complying with a request to provide records for a test period does not, without more, evidence a waiver of the taxpayer’s right to a complete audit. *Matter of James G. Kennedy*, 509 NYS2d 199. Did the Division “deliberately overlook” records which were helpful to the taxpayer? *Matter of Merrick Discount Center*, DTA No. 800362.

Was there a change in auditors? Did the original auditor appear at the hearing or at least provide an affidavit? If not, the evidence may not be sufficient to justify resort to external indices. *Matter of Kenneth Schuck Trucking*, DTA No. 816129. If the audit period was extended, were those records requested? Was an independent review of records relating to the extended audit period made? If adequate records exist for the extended audit period, the Division “cannot ignore them.” *Matter of Adamides*, 521 NYS2d 826.

Even if the taxpayer failed to comply with the Division’s record keeping regulations, it may not “prescribe the type of proof that a taxpayer must provide at hearing” in order to prevail. *Matter of John G. Avildsen*, DTA No. 809722. If the amount of tax paid was “easily ascertainable” from records provided, a denial of credit by the Division was held to constitute the “mindless elevation of form over substance” and could not be considered “anything other than an arbitrary and capricious exercise of power.” *Matter of Riluc*, 565 NYS2d 265.

Did the Division request records not typically kept by persons involved in the taxpayer’s line of busi-

ness? If so, the taxpayer has the right to substantiate the proper collection of tax due through supporting documents. *Matter of Raemart Drugs*, 555 NYS2d 458.

Assuming resort to estimate procedures was warranted, did those procedures lack a “rational basis,” or did an extrapolation yield a grossly inaccurate estimate the tax liability? *Matter of Yonkers Plumbing*, 403 NYS2d 792. Was the Division’s method “reasonably calculated” to reflect the taxes due? *Matter of W.T. Grant Company*, 2 NY2d 196, *cert denied* 355 US 869. Was the audit methodology founded upon the auditor’s “experience” without any indication that the experience relates to the present audit? *Matter of Grecian Square*, 119 AD2d 948. Was the method chosen by the Division to estimate sales arbitrary and capricious? *Matter of King Crab*, *supra*.

Was the imposition of penalties proper? Did the taxpayer make a “reasonable effort” to ascertain tax liability? *Matter of Northern States Contracting, Inc.*, DTA 806161. Was any understatement of tax unintentional? *Matter of G & R Machinery*, DTA 804590.

As these cases demonstrate, knowledge of the taxpayer’s substantive rights constitutes the best insurance against an unfavorable result. Having a meritorious case may unfortunately be insufficient to prevail at hearing unless the proper legal arguments are advanced.

V. Motions for Summary Determination

NYCRR § 3000.9(b)(1) provides that “summary determination” may be granted “if, upon all of the papers and proofs submitted, the administrative law judge finds . . . no material and triable issue of fact is presented and that the . . . judge can, therefore, as a matter of law, issue a determination in favor of any party.”

A motion for summary determination forces the Department to “lay bare” its proof at an earlier stage. In that sense, the motion serves as a

proxy for discovery. It can also provide an effective means of presenting the case to the ALJ prior to the hearing in a light most favorable to the taxpayer. Most evidence, which often consists of auditor’s testimony, his logs and other documentary evidence, is typically presented for the first time at the hearing before the ALJ in Troy.

A motion for summary judgment may eliminate the undesirable element of surprise. Surprise at hearing may derail even the strongest of cases. Once served with a motion for summary determination, the Department must respond by proving the existence of a genuine issue of triable fact. Facts not controverted in opposing papers are deemed admitted. *Fair v. Stanley Fuchs*, 631 N.Y.S.2d 153 (1st Dept. 1995) held that a party opposing a motion for summary judgment “must produce evidentiary proof in admissible form sufficient to require a trial of material questions of fact . . . mere conclusions, expressions of hope or unsubstantiated allegations or assertions are insufficient.”

Accordingly, affirmations of counsel would be insufficient to defeat the motion. Affidavits by the auditor as well as other evidence in admissible form would seemingly be required to oppose to such a motion.

VI. Tax Appeals Tribunal

Following a hearing at the Division of Tax Appeals, any party may appeal all or part of the Determination to the Tax Appeals Tribunal, provided a Notice of Exception is filed within 30 days after service of the Determination on the parties. The Tax Appeals tribunal sits as the final administrative tax tribunal in the state.

In the 2009-2010 fiscal year, the Tax Appeals Tribunal sustained the deficiency or other action asserted by the Department of Taxation in 71.7 percent of cases; it cancelled the deficiency or other action asserted in 13.0 percent of the cases; it modified the deficiency or other action asserted in 8.7 percent of the cases, and it remanded the case to the Administrative

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Law Judge in 6.5 percent of the cases.

A brief may be filed within 30 days after the filing of the Notice of Exception. 30-day extensions for filing a Notice of Exception may be granted “for cause.” In practice, such extensions are granted as a matter of course, provided a letter requesting the extension is received by the Division of Tax Appeals within the 30-day period for filing the Notice of Exception.

The Tax Appeals Tribunal, also located in Troy, has three Commissioners who serve nine-year terms and who may be removed only for cause. Tax procedure in the administrative tax tribunals is governed by rules promulgated by the Tax Appeals Tribunal. In many respects, these rules resemble procedural rules found in the CPLR. Oral argument may be requested before the Tax Appeals Tribunal, and is routinely but not automatically granted.

VII. Article 78 Review of Tax Appeals Tribunal Decisions

Taxpayers wishing to contest adverse determinations of the Tax Appeals Tribunal generally have only one choice: an Article 78 proceeding to review the determination of a “state body” (i.e., the Tax Appeals Tribunal), pursuant to CPLR §7804. Article 78 review must be commenced within 4 months following an adverse decision by the Tax Appeals Tribunal. A CPLR Article 78 proceeding is the “dotted line” in the flowchart that brings the tax dispute out of administrative tribunal system and into the New York judicial court system.

From a tax petitioner’s standpoint, Article 78 is far from perfect: it possesses treacherous statutes of limitations, it is inherently capable of providing only narrowly circumscribed relief, and it imposes onerous bonding requirements. Still, like the Spirit of St. Louis, Article 78 will at least take the taxpayer into the courtroom of the Appellate Division, where counsel may be able to convince the

Court of reversible error below.

An Article 78 petition is returnable to the Appellate Division, 3rd Department, in Albany. If corporate sales tax is in issue, the taxpayer must deposit the tax or post an undertaking. No undertaking is required to seek review of personal income and corporate tax determinations, including responsible person determinations; however, assessment and collection of these taxes may proceed during the pendency of an Article 78 proceeding.

The actual Article 78 proceeding is commenced by service of a Notice of Petition and Petition upon the parties described above made returnable to the Appellate Division, 3rd Department, on at least 20 days’ notice. At least five days before the return date of the Petition, the Commissioner must appear by serving an answer, or otherwise moving to dismiss. (A motion to dismiss could be based upon a lack of jurisdiction for failing to properly serve all parties or for failing to obtain the required bond, or dismissal could result from failing to state a cause of action.) Judicial review is limited to the record before the agency — no new evidence may be submitted. The stipulated record and a brief must be filed within 9 months after the date of commencement of the proceeding.

CPLR § 217 provides that “a proceeding against a body . . . must be commenced within four months after the determination to be reviewed becomes final and binding.” Tax Law §2016 provides that the four-month period commences after notice of the Tax Appeals Tribunal is served. The statute then provides that “service by certified mail shall be complete upon deposit of such notice . . . in a post office.” Therefore, the taxpayer actually has less than four months from receipt of the notice in which to commence an Article 78 proceeding. The Department of Taxation keeps meticulous records, including affidavits by clerks, concerning the manner in which certified copies of decisions are mailed.

Arguments made by the taxpayer concerning either the taxpayer’s own timely mailing, or the Depart-

ment’s failure in this regard, will in all likelihood fail. One might presume that only the Department of Taxation need be served with an Article 78 petition. This presumption would be erroneous: Tax Law § 2016 provides that “[t]he petitioner shall designate the tax appeals tribunal and the commissioner of taxation and finance as respondents in the proceeding for judicial review.” (The Tax Appeals Tribunal does not, however, participate in the proceeding.)

Section 2016 continues, providing that “[i]n all other respects the provisions and standards of article seventy-eight of the [CPLR] shall apply.” CPLR §7804(c) provides that “notice of petition must be served upon the attorney general by delivery of such order or notice to an assistant attorney general.”

Therefore, the Department of Taxation, the Tax Appeals Tribunal and the Attorney General must all be served in an Article 78 proceeding. One might also assume that since the taxpayer may be served with notice of the Tax Appeals Tribunal decision by certified mail, the taxpayer could, similarly, commence an Article 78 proceeding by serving the three required recipients by certified mail. This is not the case: Although CPLR §307(2) does provide that personal service may be effected upon a state agency (i.e., Department of Taxation and Tax Appeals Tribunal) by certified mail, § 307(1) appears to require personal delivery by a process server upon the Attorney General.

Additionally, one more trap awaits the unwary regarding service of process by certified mail: CPLR §307(2) provides that such service is not effective unless “the front of the envelope bears the legend “URGENT LEGAL MAIL.” Given the tangle of statutory provisions governing service, it would appear far preferable to serve all parties personally by process server, rather than to serve by certified mail and hope that all statutory requirements have been met. Although the taxpayer may have contested the

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deficiency to the Tax Appeals Tribunal without paying any disputed tax, this courtesy of the New York Legislature ends at the filing of the Article 78 petition, at least with respect to some types of tax.

Thus, a jurisdictional prerequisite to instituting an Article 78 proceeding involving, *inter alia*, sales tax or real property transfer gains tax, is the filing of a bond to cover contested amounts and court costs. Although a bond is not required in order to initiate an Article 78 proceeding based upon deficiency relating to income tax, the Department may nevertheless assess and collect a deficiency during the pendency of such an Article 78 proceeding. If the Department decides to assess tax during the proceeding, the taxpayer must either pay the deficiency or file a bond (a letter of credit may also be acceptable to the Department) pending ultimate disposition of the case.

Although it may seem unjust for the Appellate Division to dismiss meritorious cases on procedural grounds such as the failure to serve the Article 78 petition in the proper manner — and perhaps it is unjust — a body of case law has evolved which makes it virtually impossible for a court to entertain a petition which suffers from jurisdictional defects. The petition must be verified (CPLR §7804) and must comply with all provisions of the CPLR which govern pleadings.

Thus, it must make factual allegations in separately numbered paragraphs and must state a legally cognizable cause of action, or the action will be susceptible to a motion to dismiss. The Court of Appeals held in *Spodek v. New York State Com'r. of Taxation and Finance*, 628 N.Y.S.2d 256 (1995), that the commencement-by-filing provisions in CPLR §304 apply to proceedings originating in the Appellate Division. Thus, before service of the Article 78 petition on the required recipients, the Petition must be filed (and an index number pur-

chased) from the Clerk of the Appellate Division.

After purchasing the index number, personal service (preferably by a process server) must be made on the recipients. After such service is complete, proof of such service must be filed with the Appellate Division “not later than 15 days after the date on which the [four-month] statute of limitations expires.” CPLR § 306(b) Pursuant to Tax Law § 2016, the taxpayer must include as part of the petition (1) the determination of the Administrative Law Judge (ALJ), (2) the decision of the Tax Appeals Tribunal, (3) the transcript of the hearing (if any) before the ALJ, and (4) any exhibit or document submitted into evidence at any stage in the proceeding. Judicial review of the agency determination will be limited to a review of the record.

After issue has been joined (*i.e.*, the Department has served an answer or moved to dismiss), and within nine months of the date of the Notice of Petition, the taxpayer must file with the Appellate Division an original and nine copies of a reproduced full record, as well as ten copies of the taxpayer’s brief. In reviewing the determination of the Tax Appeal Tribunal, CPLR §7803 provides that the determination will be upheld if it is supported by “substantial evidence.” In addition, the burden of proof is generally on the taxpayer to show that the agency determination was arbitrary or capricious, or not supported by the evidence. This includes responsible person determinations made under the income and sales tax laws for corporate officers and employees.

After submission of the record and brief, oral argument is scheduled. Taxpayer’s counsel is generally allowed 15 minutes for oral argument. Approximately six weeks later, the Court will render a full opinion or memorandum decision. The prevailing party will then draft a proposed order for execution by the Appellate Division Clerk. After service of this order with Notice of Entry, the nonprevailing party will then have 30 days in

which to seek leave (permission) to appeal to the Court of Appeals. The Court of Appeals seldom grants leave to appeal in tax cases.

VIII. Appeals to Court of Appeals

Appeals to the Court of Appeals may be taken either by permission or as of right. In either case, no oral argument on the motion is permitted. Appeals as of right may be taken where (i) two justices dissented on a question of law in favor of the taxpayer; or (ii) the issues in dispute directly involve a constitutional question. With respect to (i), it is not enough that there have been two dissenting judges; each must have advocated judgment in favor of the taxpayer based on questions of law. With respect to (ii), even where a constitutional question is presented, the appeal will be dismissed if the decision could have been decided on other grounds. Thus, a constitutional question cannot be raised solely to obtain jurisdiction.

A motion seeking permission to appeal may be based upon three grounds: (i) the decision conflicts with a prior Court of Appeals decision; (ii) a novel question is presented; or (iii) a question of substantial public importance is presented. Permission is typically sought under (ii) or (iii). The motion must include (a) a concise statement of facts; (b) a statement of the procedural history and a showing that the motion is timely; (c) a showing that the Court has jurisdiction; (d) an argument as to why the case merits review; and (e) an identification of portions of the record where the questions sought to be reviewed were preserved for appellate review. Within 10 days taking an appeal by right or by permission, the petitioner must “perfect” the appeal by filing a jurisdictional statement. The petitioner must then file and serve his brief, with the record and original exhibits. Leave to appeal to the Court of Appeals, rarely granted, may be sought if the taxpayer in the Appellate Division. In recent years, the U.S. Supreme

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Court has granted certiorari to relatively few petitioners involving substantive state tax issues.

The Appellate Division will affirm if it finds the decision was (i) supported by “substantial evidence” and was not (ii) erroneous, arbitrary or capricious. Following submission of the record and briefs, oral argument before five judges will be scheduled in the Appellate Division. Within 4 to 6 weeks, a decision will be handed down. An appeal to the Court of Appeals from an adverse decision of the Appellate Division must be taken within 30 days after being served with a notice of entry. Failure to timely take an appeal is a fatal jurisdictional defect that will foreclose all further relief. The Court of Appeals generally reviews only questions of law. However, it may also review the Appellate Division’s reversal of the administrative tribunal’s finding of fact or exercise of discretion.

IX. Declaratory Relief Against Department of Taxation

Although the administrative dispute mechanism is fairly administered by competent judges, tax disputes often result in manifest unfairness to the taxpayer, since protest and filing deadlines are strictly enforced, notices are unclear, and unintended forfeiture of rights frequently occurs. Taxing statutes are narrowly construed and administrative tribunals have little or no equitable jurisdiction. Moreover, Article 78 proceedings are procedurally and substantively weighted against the taxpayer, the standard of review being the difficult to surmount “arbitrary and capricious” formulation. In the federal arena, suits against the IRS may proceed in federal courts only if the taxpayer has paid the tax and then sues for a refund; otherwise the taxpayer must litigate in Tax Court. The doctrine of sovereign immunity will, with few exceptions, pose an impenetrable bar resulting in dismissal of most actions brought by the taxpayer

in federal court, except when expressly authorized by statute.

Yet, the doctrine of sovereign immunity exerts less pull in New York state courts. In fact, the Court of Appeals has expressly recognized that administrative remedies are not the sole method of contesting the validity of a taxation statute: “A tax assessment may be reviewed in a manner other than that provided by statute where the constitutionality of the statute is challenged or a claim is made that the statute by its own terms does not apply...” *Slater v. Gallman*, 377 N.Y.S.2d 448. Thus, even a taxpayer who has contested — and lost — in the administrative tribunals, may seek another “day in court” in state supreme court, a naturally more hospitable venue. Moreover, once in supreme court, the Department’s own counsel will mostly likely transfer the file to the Attorney General’s office to litigate the matter. Since the Attorney General may not have the same institutional loyalty to the Department, a satisfactory accord may be reached even where none was possible the Department’s counsel at the administrative tribunals stage.

Challenging the constitutionality of a taxing statute is difficult, as is succeeding in an argument that a taxing statute is unconstitutional or by its terms inapplicable. Nonetheless, the legislature is by no means incapable of enacting vague or unconstitutional statutes, and a serious challenge in supreme court may in the end vindicate the taxpayer’s interests. Thus, in *Tennessee Gas Pipeline Company v. Urbach*, 96 NY2d 124 (2001), a declaratory judgment action, the Court of Appeals reversed the Appellate Division and declared the gas import tax unconstitutional as violative of the Commerce Clause.

In practice, a declaratory judgment action in state supreme court is commenced by filing a summons and complaint as in any other civil action. The usual rules of procedure as provided in the CPLR apply. Often, a complaint is brought on by an order to show cause (OSC) seeking injunctive relief and a stay of collection until a

hearing has been held. The Department does not like to litigate outside of its administrative tribunal forum. Nevertheless, a taxpayer who seeks a declaratory judgment and alleges that a statute is unconstitutional or inapplicable is entitled to a judgment declaring the parties’ rights. The appellate division has held that it is improper to “dismiss” a complaint seeking a declaratory judgment, since the proper action is to declare that the statute is — or is not — constitutional. If there is a real question as to whether the statute is unconstitutional or inapplicable, the Attorney General, on its client’s — the Department’s — instruction, may seek to resolve the dispute without forcing the court to render a decision on the merits, which could further impede the Department’s efforts to collect tax against other similarly situated taxpayers if the Department were to lose and the statute were held to be inapplicable or unconstitutional.

Even if the taxpayer seeking a declaratory judgment appears unlikely to succeed on the merits, the mere presence of the taxpayer and his attorney in state supreme court with a Summons and an OSC against the Department and the Commissioner will more likely elicit the attention of an attorney or official with the power and inclination to settle the dispute than would the taxpayer on the receiving end of a telephone call from a collection agent. The declaratory judgment action can be an extremely useful device, especially where other viable options appear few.

POST MORTEM TAX PLANNING, CONT.

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Any tax not paid on or before the due date (without regard to extensions) will attract interest at the underpayment rate established by IRC § 6621(a)(2). IRC § 6601(a).

New York imports most of the information contained on the federal Form 706 onto its own estate tax return, Form ET-706. Since the New York estate tax exemption amount is only \$1 million, an estate must complete and submit a federal Form 706 along with the ET-706 whether or not the federal Form 706 is required to be filed with the IRS.

II. New York Estate Tax Imposed on Nonresidents

New York imposes estate tax on a *pro rata* basis to nonresident decedents with property subject to New York estate tax. New York imposes no estate tax on nonresidents' intangibles. TSB-M-92 provides that "New York has long maintained a tax policy that encourages nonresidents to keep their money, securities and other intangible property in New York State." TSB-A-85(1) further provides that shares of stock of a New York corporation held by a nonresident are not subject to New York estate tax since shares of stock are considered intangible personal property.

TSB-A-08(1)M, provides that an interest of a nonresident in an S Corporation which owns a condominium in New York is an intangible asset provided the S Corporation has a legitimate business purpose. Presumably, if the S Corporation had only a single shareholder, and its only purpose was to hold real estate, New York could attempt to "pierce the veil" of the S Corporation and subject the condominium to New York estate tax in the estate of the nonresident.

Real property is generally taxed in the state where it is situated. Since LLC or partnership interests are intangibles, they would not be subject to New York estate tax. Therefore, nonresidents who own New York real

property might consider converting the real property to personal property by contributing the real property to personal property by contributing the real property to an LLC and taking back membership interests.

III. Elections to Defer Payment of Estate Tax

However, a request for an extension of time to pay the estate tax may be made under IRC § 6161 or IRC § 6166. Under IRC § 6161, an extension of up to ten years to pay the estate tax for "reasonable cause" or to prevent "undue hardship." Treasury regulations provide examples of what may constitute reasonable cause or undue hardship. Under IRC § 6166, an election may be made to pay estate tax in installments over 14 years, provided a "closely held business" interest exceeds 35 percent of the estate.

IV. Alternative Valuation Date

Under IRC § 2032(a), an executor may elect to value estate assets six months after the decedent's date of death. The election, made on the estate tax return, can be useful if estate assets have depreciated between the date of death and the "alternate valuation date" (AVD). If the election is made to value estate assets on the AVD, it will apply to all estate assets. Any assets sold during the six month period preceding the alternative valuation date are valued as of the date of sale or distribution.

The AVD election is made on Form 706. Therefore, if an extension to file the return is made, a decision to make the election can also be deferred until that time. Although the statute advises that "[s]uch election, once made, shall be irrevocable," the regulations grant some latitude by providing that "in no case may the election be exercised, or a previous election changed, after the expiration of" the due date the return, with extensions. IRC § 2032(d); Treas. Regs., § 1.2032

-1(b)(1).

IRC § 2032(a)(3) precludes the use of the AVD for changes resulting from the "mere lapse of time." In *Kohler v. Com'r*, T.C. Memo 2006-152, the Tax Court found that an estate could utilize a lower valuation where a post-death corporate reorganization reduced the value of the decedent's stock. Following the *Kohler* decision, the proposed regulations were amended to provide that AVD could not be used for changes resulting from the mere lapse of time or "because of economic conditions."

V. The Decedent's Final Income Tax Return

A decedent's final income tax return must be filed by April 15 of the year following death. A joint return may be filed by the Executor if the decedent's spouse did not remarry during the year. If no Executor has been appointed by the filing date, the surviving spouse may file a joint return. A later appointed Executor may revoke the surviving spouse's election to file a joint return by filing a separate return within one year from the due date of the return, including extensions.

Liability issues may arise if a joint return is filed, since the Executor and spouse become jointly and severally liable for any tax and penalties, unless otherwise agreed. Therefore, as is the case with any joint return, the Executor should exercise caution before doing so, even if tax savings would arise by doing so.

Income tax liability arising before death constitutes a *bona fide* debt of the estate. Accordingly, such tax liability may be deducted on the estate tax return. However, if a joint return is filed, only that portion of the income tax attributable to income for which the decedent was liable may be deducted on the estate return.

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*(Continued from page 21)***VI. Income in Respect of Decedent**

IRC §691 provides that income earned by the decedent before death, but collected after death, must be reported as income by the decedent's estate. Such income is termed "income in respect of a decedent" or IRD. IRD items typically include (i) interest; (ii) salary or commissions earned; (iii) dividends whose record date preceded death; or (iv) gain portions of collections on a pre-death installment sale.

IRC §2033 provides that a decedent's gross estate equals the value of all property to the extent of the decedent's interest at the time of death. Since IRD is an "interest" of the decedent at his time of death, IRD is also subject to estate tax. To mitigate the harshness of IRD being subject to income as well as estate tax, IRC §691 (c) provides an income tax deduction equal to the difference between the actual estate tax payable and the estate tax that would have been payable had the IRD been excluded from the gross estate.

Note that IRD items, in contrast to most other items included in the gross estate, do not receive a basis step up at the decedent's death. IRC §1014 (c). This can result in unnecessary income tax if the decedent sells appreciated property before death using the installment method to report gain. In this case, the gross profit ratio would be high, reflecting the appreciation in the property. Had the decedent's estate sold the property instead, there would be no gain because the property would have received a stepped up basis at the decedent's death under IRC § 1014(a).

The mirror image of income in respect of a decedent is "deductions in respect of a decedent" or DRD. IRC § 691(b). These deductions consist of expenses which the decedent accrued before death but had not paid by the time of his death. DRD includes trade or business expenses, interest, taxes, depletion, and other items which were not deducted on the decedent's final income tax return. Since these items constitute debts, they may also be de-

ducted on the decedent's estate tax return, thus providing the estate with a double benefit.

VII. Fiduciary Income Tax

The decedent's estate must file a fiduciary income tax return by April 15th of the year following the year of the decedent's date of death, unless the estate chooses a noncalendar year. The primary reason for selecting a fiscal taxable year would be to achieve a deferral of income. Since all estate distributions to beneficiaries are treated as being made on the last day of the estate's taxable year, choosing a fiscal tax year may enable the executor to achieve this income tax deferral.

Under IRC § 6654(l), an estate must make estimated payments of income tax. However, estates are exempt from this requirement for two years. Since a revocable trust may elect to be taxed as an estate under IRC § 645, an electing revocable trust will also not be required to make estimated income tax payments for two years.

To illustrate, assume decedent died on February 15th, 2011, and that the estate elected a taxable year ending on January 31st, 2012. Beneficiary receives a taxable distribution on March 31st, 2011. Since all estate distributions are treated as being made on the last day of the estate's taxable year, the beneficiary would be treated as receiving the distribution on January 31st, 2012, which is the last day of the estate's taxable year. This income would be reported by the beneficiary on his 2012 income tax return, due on April 15th, 2013.

When considering the concept of DNI, one should distinguish IRC §102, which provides that gross income does not include the value of property acquired by gift or inheritance. To illustrate the distinction, assume decedent died on November 15th, 2011, seized of farmland in Iowa, and left the land to the trustees of a discretionary trust intended to benefit his daughters. There would be no DNI and no income tax with respect to

the bequest itself. Income from the farm generated in 2011 until the date of the decedent's death would be reported April 15th, 2012, on the final income tax return of the decedent. The estate would report fiduciary income on its first fiduciary income tax return. Assuming all of the trust's distributable net income was distributed to the daughters in 2011, the trust would deduct this DNI from trust income. The trust would report net income after the subtraction for DNI, and the daughters would report their respective shares of DNI.

If the terms of the trust required all income to be distributed to the daughters in a given year, and no principal was distributed, the trust would be a "simple" trust for income tax purposes for that taxable year. If the terms of the trust required all income to be distributed in a given year, but principal was distributed in that year, then the trust would be a "complex" trust for fiduciary income tax purposes. Finally, if the trust did not require that all income be distributed, then the trust would be a complex trust for all tax years, regardless of whether principal distributions were made in that year.

Some expenses of administering an estate may be deducted on either the estate tax return or on the fiduciary income tax return. Remainder beneficiaries of a trust may be affected by the choice of where the deductions are taken. If an expense of administration is taken on the fiduciary income tax return, this will reduce income tax liability of the income beneficiaries of the trust. However, the burden will be shifted to the remainder beneficiaries, since the gross estate will be larger.

The Uniform Principal and Income Act has been adopted in 26 states, including New York. Five states, also including New York, have enacted statutes enabling trusts to adopt a "unitrust" definition of income. Thus, EPTL 11-2.3(b)(5)(A) provides that where the terms of a trust describe the amount that "may or must be distributed to a beneficiary by referring to the trust's income, the pr-

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dent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable. . . .”

Estates and trusts may also elect to treat distributions made within the first 65 days of the taxable year as being paid on the last day of the preceding taxable year. The election is made on Form 1041. IRC § 663(b). The election may not be made if the estate tax return is filed more than one year after the time prescribed by law (including extensions) for filing the return.

VIII. Administration Expenses

Certain expenses incurred by the decedent and paid before death may be deducted only on the decedent's final income tax return. Those include (i) medical and other deductible expenses paid prior to death; (ii) capital loss carryovers; (iii) charitable contribution carryovers; and (iv) net operating loss carryovers.

Medical expenses incurred before death but paid after death may be deducted either on the decedent's final income tax return (provided they are paid within one year of death) or on the estate tax return. To claim the deduction on the final income tax return, the executor must file a statement certifying that the expense was not claimed as a deduction on the estate tax return.

Expenses of administration actually and necessarily incurred in administering the estate are deductible. IRC § 2053; Treas. Regs. § 1.2053-3. Some estate administration expenses may be deducted either on the estate tax return or on the fiduciary income tax return. Under IRC § 642(g), no income tax deduction for expenses is allowed unless the executor files a statement with the IRS agreeing not to claim those expenses as deductions on the estate tax return.

The election may be made on an item-by-item basis. Treas. Regs. § 1.642(g)-2. The election is irrevocable after the statement is filed. The waiver

statement must be filed before the statute of limitations for assessment on the income tax return runs. Therefore, if it is unclear on which return it would be preferable to take the expenses, it may be prudent to wait until the statute of limitations is about to expire.

Expenses deductible either on the estate or fiduciary income tax return (or split between them) include (i) appraisal expenses; (ii) court costs; (iii) executor's commissions; (iv) attorney's fees; (v) accountant's fees; (vi) selling expenses; and (vii) costs of preserving, maintaining and distributing estate property. Medical expenses paid within a year of death may be deducted on either the 706 or the 1041, but may not be split.

Some expenses may be deducted only on the estate tax return. These include (i) personal expenses that are not deductible for income tax purposes (e.g., funeral expenses); (ii) income and gift taxes; (iii) or expenses incurred in producing tax-exempt income.

Other expenses are deductible only on the decedent's final income tax return. These include (i) net operating losses of the decedent; (ii) capital losses of the decedent; and (iii) unused passive activity losses of the decedent.

Deductions in respect of a decedent, which are the mirror-image of income in respect of a decedent, may be deducted on the fiduciary income tax return under IRC § 691(b), as well as the estate tax return under IRC § 2053. These deductions consist of income tax deductions which accrued prior to the decedent's death, but which were never deducted on an income tax return. These expenses are also deductible under IRC § 2053 as estate administration expenses that reduce the size of the gross estate.

Items of DRD include (i) IRC § 162 business expenses; (ii) IRC § 163 interest expenses; (iii) IRC § 212 expenses incurred in the production of income; and (iv) § 164 real estate taxes and state and local income taxes.

Any loss carryovers which exist

when the estate terminates may be utilized by the beneficiaries under IRC § 642(h).

In most cases, if there is an estate tax liability, it will be preferable to claim the expense on the decedent's estate tax return, since the estate tax rate exceeds the income tax rate. The estate tax is also due nine months after the date of the decedent's death, whereas the income tax may be deferred until a later year. However, the disparity has been reduced of late since the maximum estate tax rate is now 35 percent. If there is no estate tax liability — either because the taxable estate does not exceed the applicable exclusion amount, or the taxable estate has been vanquished by the marital deduction — then taking the deduction on the income tax return will be the only viable option.

Another situation where it would not be preferable to claim administration expenses on the estate tax return is where there has been a formula bequest in the Will to maximize the marital deduction. Taking the deduction on the estate tax return in this case would simply reduce the marital bequest — without any savings in estate taxes. If the marital bequest is designed to eliminate estate taxes, there is no need to produce additional estate tax deductions. Therefore, in this case, it would be preferable to deduct the administration expenses on the fiduciary tax return.

IX. Election to Treat Trust as Part of Estate

During the 1990's, revocable trusts were in vogue in some states, especially California and Florida. They were promoted as vehicles to avoid probate. Claims were even made that such trusts reduced estate taxes or provided asset protection. The estates of those who depended on those trusts to effectuate the decedent's testamentary wishes were often disappointed. Since New York had enacted little statutory law governing *inter vivos* trusts as testamentary vehicles, trustees have had

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difficulty determining whether some assets had been effectively transferred to the trust. While assets such as real estate or brokerage accounts could be retitled into the name of the trust, the adequacy of transfers of personal property was sometimes a significant problem. Some revocable trusts contained mere “schedules” of personal assets which were supposedly transferred to the trust.

The problems created by the use of such trusts as testamentary vehicles greatly exceeded the principal benefit conferred on those using such trusts — the avoidance of probate. Ironically, probate was usually required anyway, since assets often remained which had not been effectively transferred to the inter vivos trust. Thus, a “pour over” Will was typically required in addition to the revocable inter vivos trust.

Fortunately, most estate planners discerned quite early that the touted attributes of inter vivos trusts as Will substitutes were for the most part illusory. Thus, New York never joined the revocable trust bandwagon. For the most part, estate planners in New York never abandoned the Will as the primary testamentary device.

Despite their considerable limitations, revocable *inter vivos* trusts have accomplished one task extremely well: They can avoid the necessity of ancillary probate in another state. Thus, if a New York resident creates an *inter vivos* trust and deeds into that trust a Florida condominium, ancillary probate of the decedent’s will in Florida will not be required at the decedent’s death.

Recognizing the frequent use of revocable trusts, Congress leveled the playing field somewhat for those who chose to incorporate revocable *inter vivos* trusts into their estate plan, or chose to use them as their exclusive testamentary vehicle. Thus, IRC § 645 makes available to “qualified” revocable trusts many of the elections available to estates. To constitute a qualified revocable trust, the trust must be one

with respect to which the decedent retained the power to revoke the trust until his death. Accordingly, under IRC § 645(a), if both the executor (if there is one) and the trustee make an election, the trust will be treated as part of the estate, rather than as a separate trust.

The election applies for two years from the date of the decedent’s death if no estate tax return is filed. If an estate tax return is filed, the election terminates six months after the date of final determination of estate tax liability. IRC § 645(b)(2). Treas. Regs. § 1.645-1(f)(2). Once made, the election is irrevocable.

A decedent’s estate may elect a fiscal tax year, provided the first year does not exceed 12 months, and the fiscal year ends on the last day of the calendar month. IRC § 441(d). Since a revocable trust may elect to be taxed as an estate under IRC § 645, an electing revocable trust may also choose a non-calendar taxable year. The election is made by filing a return by the due date of the return, which would be no more than three and a half months after the month selected.

X. Distributions in Kind

Special income tax rules apply to certain distributions made in kind to beneficiaries. The general rule is that an estate recognizes no gain when distributions to beneficiaries are made in kind. The beneficiary takes a substituted basis in the distributed property under IRC § 643(e)(1). However, an exception to this rule applies when funding of a *pecuniary* bequest with appreciated property. If appreciated (or depreciated) property is distributed in kind to fund a pecuniary bequest, the distribution is treated as a sale or exchange of estate property, and the estate will recognize gain (or loss).

There may be times when the executor may wish to recognize gain or loss on the distribution of appreciated property in kind, even when not required to do so. This would be the case if appreciated property were distributed in kind, but was not being distribut-

ed in order to satisfy a pecuniary bequest.

IRC § 643(e)(3) provides that an executor may elect to have the estate recognize gain or loss on the date of the distribution to the beneficiary. The amount of gain or loss is determined by calculating the amount of gain or loss that would accrue if the estate had sold the property to the beneficiary on the distribution date. Once made, the election is irrevocable. If the election is made, the basis to the beneficiary of the distributed property equals the estate’s basis in the property, adjusted for any gain or loss recognized by the estate in the distribution.

X. Preparer Penalties

Under revised IRC §6694, a return preparer (or a person who furnishes advice in connection with the preparation of the return) is subject to substantial penalties if the preparer (or advisor) does not have a reasonable basis for concluding that the position taken was more likely than not. If the position taken is not more likely than not, penalties can be avoided by adequate disclosure, provided there is a reasonable basis for the position taken. Under prior law, a reasonable basis for a position taken means that the position has a one-in-three chance of success. P.L. 110-28, §8246(a)(2), 110th Cong., 1st Sess. (5/25/07).

This penalty applies to all tax returns, including gift and estate tax returns. The penalty imposed is \$1,000 or, if greater, one-half of the fee derived (or to be derived) by the tax return preparer with respect to the return. An attorney who gives a legal opinion is deemed to be a non-signing preparer. The fees upon which the penalty is based for a non-signing preparer could reference the larger transaction of which the tax return is only a small part.

XI. Late Filing & Payment Penalties

A failure-to-file penalty of 5 percent per month is imposed for each

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month the failure causes the return to be filed past the due date (including extensions). The penalty may not exceed 25 percent of the tax, and it may be waived for reasonable cause.

New York imposes a similar penalty under Tax Law § 685(a)(1), which may also be abated for reasonable cause. See 20 NYCRR § 2392.1(a)(1); § 2392.1(d)(5), and § 2392.1(h); and *Matter of Northern States Contracting Co., Inc.*, DTA No. 806161, Tax Appeals Tribunal (1992), (“in determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer’s efforts to ascertain the proper tax liability”); and *Matter of AILS Systems, Inc.*, DTA No. 819303, Tax Appeals Tribunal (2006), (the Tribunal took notice of the “hallmarks of reasonable cause and good faith,” which included “efforts to ascertain the proper tax liability.”)

A failure-to-pay penalty of 0.5 percent per month is imposed for each month the failure causes payment to be made past the due date (including, if applicable, extensions). The penalty may not exceed 25 percent of the tax, and it may be waived for reasonable cause. New York State imposes a similar penalty, which may also be abated for reasonable cause. Tax Law § 685(a)(2).

XII. Appraiser Penalties

The Pension Protection Act of 2006 added new appraiser penalties. Under IRC § 6695A, a penalty may be imposed on an appraiser if he knew or should have known that the appraisal would be relied upon for tax purposes. The penalty is the greater of 10 percent of the amount of tax attributable to the underpayment of tax attributable to the valuation misstatement, or \$1,000, but in any case not more than 125 percent of the income received by the appraiser in connection with preparing the appraisal. The penalty can be avoided if the appraiser establishes

that the appraisal value was “more likely than not” the correct value.

IRC § 6701 imposes a penalty of \$1,000 against any person who assists in the preparation of a return or other document relating other than a corporation) who knows (or has reason to believe) that such document or portion will be used, and that its use would result in an understatement of tax liability of another person. The IRS may disqualify any appraiser against whom a penalty has been assessed. (Circular 230, § 10.51(b)).

If a “valuation understatement” results in an underpayment of \$5,000 or more, a penalty of 20 percent will be assessed with respect to the underpayment attributable to the valuation understatement. IRC § 6662(g). The penalty increases to 40 percent if a “gross valuation understatement” occurs. The penalty will not apply if reasonable cause can be shown for the understatement. IRC § 6664(c)(2).

A valuation understatement occurs if the value of property reported is 65 percent or less than the actual value of the property. A gross valuation understatement occurs if the reported value is 40 percent or less than the actual value of the property. IRC § 6662(h).

XIII. Estate Tax Liens

Under IRC § 6321, a general tax lien may be imposed on all real and personal property owned by any person liable to pay any tax who neglects or refuses to pay such tax after a demand has been made. The general tax lien applies not only to all property owned by the taxpayer at the time the lien comes into effect, but also to all after-acquired property. Under IRC § 6322, the lien commences when the tax is assessed and continues until it becomes unenforceable by lapse of time. Under IRC § 6502, the period of collection is ten years.

Under IRC § 6324, a special estate tax lien attaches to all property which comprises part of the decedent’s estate at death. No formal assessment need be made to create this special

lien. The special lien for estate taxes expires 10 years from the date of the decedent’s death.

XIV. Negligence and Fraud Penalties

An accuracy-related penalty is imposed on the portion of an underpayment attributable to negligence, which is defined as “any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code.” The penalty imposed equals 20 percent of the underpayment. IRC §§ 6662, 6662(c).

IRC § 7203, which addresses “omissions,” provides that any person who “fails to make a return, keep any records, or supply any information, who willfully fails to pay such . . . tax, make such return, keep such records, or supply such information,” shall be guilty of a misdemeanor, and subject to a fine of not more than \$25,000 and imprisonment of not more than one year.

The willful attempt to “evade” any tax (including gift and estate tax) constitutes a felony, punishable by a fine of “not more than \$100,000 (\$500,000 in the case of a corporation)” and imprisonment of not more than 5 years, or both, together with costs of prosecution. IRC § 7201.

Generally, the IRS must assess a deficiency within the later of (i) three years of the date when the return is filed or (ii) the due date of the return, with extensions. IRC § 6501(a). This period is tolled for 90 days if a notice of deficiency has been mailed. IRC § 6503(a)(1). The period is extended to six years if the taxpayer omits from the return more than 25 percent of gross income (or gross estate).

The statute of limitations for assessing a false or fraudulent return never runs. IRC § 6501(c)(1). If the taxpayer fails to file an income tax return where one is due, the IRS may assess income (or estate) tax at any time. Tax assessed may be collected for a period of ten years following assess-

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ment. IRC §6502(a).

XV. Fiduciary and Beneficiary Liability

An executor is a fiduciary. The IRS also has the power to proceed directly against a fiduciary for the payment of estate tax if any assets of the estate have been distributed before the executor has obtained a release from liability. In correspondence to an executor which it seeks to hold liable for unpaid estate taxes, the IRS may reference 31 U.S.C. § 3713. The statute provides: "A representative of a person or an estate . . . paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment of unpaid claims of the Government." This statute, which creates fiduciary liability, provides that the government must be paid first out of estate funds. If an estate possesses insufficient assets to pay the deceased's debts, the government will have first priority in proceedings under Chapter 11.

Although the statute does not create a lien *per se*, it does set forth a priority of payment. The statute would prevent the executor from paying any debts to others while debts are owing to the United States. The case law, though not uniform, has held that the distribution by an executor of assets would subject the executor to personal liability.

On the other hand, if no assets are distributed, the fiduciary does not bear personal responsibility for the payment of estate taxes. If the fiduciary distributes assets or sells assets and distributes the proceeds while estate tax liability exists, the IRS may hold the fiduciary liable for the payment of estate taxes.

The same procedures used by the IRS when collecting taxes from an estate are available in enforcing the personal liability of a fiduciary. Under IRC §6901(c)(3), the IRS may assess taxes against a fiduciary until the expi-

ration of the period for collection of the estate tax. Although the Code does not specifically provide for a collection period against a fiduciary, presumably the ten year collection period would be applicable.

Under IRC §6501(d), the executor may request "prompt assessment" of income and gift taxes attributable to prior returns filed by the decedent. This will shorten the statute of limitations for collection and may benefit the executor as well as the beneficiaries. The executor may also file a written application requesting release from personal liability for the decedent's income and gift taxes. If the IRS fails to notify the executor of any amount due within nine months of such request, the executor will be released from liability.

The executor may also incur personal liability for estate taxes. The executor may request a release from liability with respect to any estate tax found to be due within nine months of making the application if the application is made before the return is filed, or within nine months of the due date of the return. An executor so discharged cannot be held personally liable for any deficiency in the estate tax. IRC §2204(a).

The executor may remain liable for estate tax in situations where beneficiaries seek early distributions. In these cases, the executor may seek to protect him or herself by funding an escrow agreement or reaching some other satisfactory arrangement with the beneficiaries in the event liability is imposed on the executor in the future.

XVI. Revaluation of Lifetime Gifts

Taxpayers or decedents may have neglected to file gift tax returns during their lifetime for large gifts. Although no gift tax liability may have arisen by virtue of the earlier gift, the failure to file the Form 709 may give the IRS an inroad to review the value of a gift made many years earlier. This is because the three-year period of limitations for auditing a gift tax re-

turn does not commence unless the gift is "adequately disclosed" on a filed gift tax return. It is for this reason that persons making sales to grantor trusts may consider filing a gift tax return even where none is technically required, since it is thought that this may commence the three-year period of limitations on IRS review of the value of the property sold.

Beneficiaries of an estate also bear personal liability for unpaid estate taxes with respect to both probate and nonprobate assets. IRC §§ 6901(a)(1) and 6324(a)(2). Transferee liability cannot exceed the value of the assets on the date of transfer. *Com'r v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). Under IRC § 6901(c), the IRS may impose transferee liability for one year after the expiration of the period of limitations for imposing liability on the transferor.

XVII. Valuing Estate Assets

An accurate valuation of estate assets is essential in determining the correct estate tax and defending the estate in the event of an audit. If the IRS or NYS determines on audit that the value of assets reported is incorrect, not only will the estate tax liability increase, but penalties may apply. Valuation discounts that are successfully challenged by the IRS may result in tax deficiencies of a magnitude sufficient to attract underpayment penalties.

The value of stocks traded on an established exchange or over the counter is determined by calculating the mean between the highest and lowest quoted selling price on the date of the gift. Treas. Reg. §25.2512-2(b)(1). Publicly traded stocks reference their market value and should include CUSIP (Committee on Uniform Identification Procedure) information. Valuation services provide historical information for a fee. Historical stock quotes are also available on the internet.

If no sales on the valuation date exist, the instructions state that the

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mean between the highest and lowest trading prices on a date “reasonably close” to the valuation date may be used. If no actual sales occurred on a date “reasonably close” to the valuation date, bona fide bid and asked prices may be used. Treas. Reg. §20.2031-2(e) provides that a blockage discount may be applied where a large block of stock may depress the sales price.

Surprisingly, real estate requires no appraisal or formal valuation. If an appraisal is obtained, it should be attached to the return. Contrary to what some intuitively assume, Treas. Reg. §25.2512-1 provides that local property tax values are not relevant unless they accurately represent the fair market value. Even though not required, a date of death valuation is often obtained in the event an audit is anticipated. Generally, the value of real property is the price paid in an arm’s length transaction before the valuation date. If none exists, comparable sales may be used.

Treas. Reg. §25.6019-4 provides that the real property should contain a legal description such that the real property may be “readily identified.” This would include a metes and bounds description (if available), the area, and street address.) When determining the fair market value of real property, valuation discounts for (i) lack of marketability; (ii) minority interest; (iii) costs of partition; (iv) capital gains; and certain other discounts may be taken into consideration.

Lack of marketability and minority discounts may be available for gifts of closely held stock. Rev. Rul. 59-60, an often-cited ruling, sets forth a list of factors to be considered when valuing closely held businesses. Those factors include (i) the nature of the business and the history of the enterprise; (ii) the economic outlook in general and the condition and outlook of the specific industry in particular; (iii) the book value of the stocks and the financial condition of the business; (iv) the earning capacity of the company; (v) the dividend-paying capacity of

the company; (vi) goodwill and other intangible value; (vii) sales of stock and the size of the block of stock to be valued; (viii) the market price of stocks of a corporation engaged in the same or a similar line of business having their stocks actively traded in a free open market, either on an exchange or otherwise. If the decedent was a key person in the closely held business, an additional discount may be applicable. *Furman v. Com’r*, T.C. 1998-157, recognized a key man discount of 10 percent where the services of the decedent were important in the business.

The fair market value of closely held stock is determined by actual selling price. If no such sales exist, fair market value is determined by evaluating the “soundness of the security, the interest yield, the date of maturity and other relevant factors.” Treas. Reg. §25.2512-2(f). The gift tax instructions (by analogy) state that complete financial information, including reports prepared by accountants, engineers and technical experts, should be attached to the return, as well as the balance sheet of the closely held corporation for “each of the preceding five years.” Closely held stocks should be valued by a professional valuation appraiser.

Despite opposition by the IRS, courts have continually held that the cost of an eventual capital gains tax reduces the value of closely held stock. *Jelke v. Com’r*, T.C. Memo 2005-131, *rev’d*, ___ F.3d ___, 2007 WL 3378539 (11th Cir. 11/16/07), allowed a full built-in capital gains discount. Discounts applicable to closely held corporations may exceed those for partnerships or LLCs, since even less of a market may exist for stock in a closely held family business compared to an interest in an LLC or partnership, which typically hold interests in real estate.

No appraisal is required for tangible personal property such as artwork, but if one is obtained, it should be attached to the return. Rev. Rul. 96-15 delineates appraisal requirements, which include a summary of the ap-

praiser’s qualifications, and the assumptions made in the appraisal. If no appraisal is made, the return should indicate how the value of the tangible property was determined. The provenance of artwork will affect its transfer tax value. As is the case with large blocks of stock, if large blocks of artwork are gifted, a blockage discount may apply. *Calder v. Com’r*, 85 TC 713 (1985).

The IRS does not recognize fractional interest discounts in the context of artwork, since the IRS believes that there is “essentially no market for selling partial ownership interests in art objects. . .” Rev. Rul. 57-293; *see Stone v. U.S.*, 2007 WL 1544786, 99 AFTR2d 2007-2292 (N.D. Ca. 5/25/07), (District Court found persuasive testimony of IRS Art Advisory Panel, which found discounts applicable to real estate inapplicable to art; court allowed only 2 percent discount for partition.)

XVIII. Special Use Valuation

Real estate and farm property is generally valued for estate tax purposes at fair market value based on its highest and best use. The special use valuation election under §2032A can reduce the estate tax value of qualified real property or an existing business based on its actual or “special” use. The greatest decrease in value allowed in 2011 is \$1 million. The qualified real property must be located in the U.S. and have been used by the decedent or a member of his or her family who materially participated in the trade or business for at least five of the eight years preceding the date of death, disability or retirement.

To qualify for the election, the adjusted value of the real or personal property must equal 50 percent or more of the adjusted value of the gross estate. In addition, the adjusted value of the real property must equal 25 percent or more of the adjusted value of the gross estate. The property must pass from the decedent to a “qualified heir” with a present interest in the

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property.

Qualified heirs encompass a large class of persons, including (i) the decedent's ancestors; (ii) the decedent's spouse; (iii) lineal descendants of the decedent or the decedent's spouse; (iv) lineal descendants of the parents of the decedent or the parents of the decedent's spouse; and (v) spouses of lineal descendants of parents of the decedent or spouses of lineal descendants of the parents of the decedent's spouse. IRC §§ 2032A(e)(1) and (e)(2).

The election is made by the Executor on the estate tax return and once made, is irrevocable. A properly executed "notice of election" and a written agreement signed by each person with an interest in the property must be attached to the estate tax return. IRC § 2032A(c). Any estate can be recaptured if, within ten years after the decedent's death, the property is disposed of, or if the qualified heir ceases to use the property for the qualified use. The written agreement subjects all qualified heirs to personal liability for payment of the recaptured estate tax.

If the Executor is unsure whether the estate qualifies for the election because of uncertainty as to whether the percentage tests can be met, the Executor may file a protective election, pending a final determination of values. Treas. Regs. § 20.2032A-8(b).

XIX. Post-Mortem Events

All federal circuits, except the Eighth, have long adhered to the view that post-mortem events must be ignored in valuing claims against an estate. *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929) held that "[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of the opinion that it cannot be done, but that the value of the wife's life interest must be established by the mortality tables."

However, Proposed Regs. §20.2053-1(a)(1) state that post mor-

tem events must be considered in determining amounts deductible as expenses, claims, or debts against the estate. Those proposed regulations limit the deduction for contingent claims against an estate by providing that an estate may deduct a claim or debt, or a funeral or administration expense, only if the amount is actually paid. An expenditure contested by the estate which cannot not be resolved during the period of limitations for claiming a refund will not be deductible.

XX. Preventing Loss of Basis

Many assets today will have a fair market value less than the adjusted basis. Since under IRC §1014 a basis adjustment is made at death to fair market value, a loss of basis could occur in many situations. Various strategies may be considered to reduce the likelihood of this problem arising:

¶ Losses may be recognized on sales to unrelated parties. IRC § 1001 (a). Losses on sales to related parties cannot be recognized, but basis is carried over to related party. IRC §267.

¶ No gain or loss is recognized on transfers made between spouses, whether by gift or sale. IRC § 1041(a). The transferee spouse will take a substituted basis in the asset sold or gifted. IRC § 1041(b); Treas. Reg. § 1.1041-1T(d), Q&A 11. Gifts to a spouse qualify for the unlimited marital deduction. IRC §2523. Therefore, no income tax or gift tax consequences arise when property is sold or gifted between spouses.

¶ Gifts of property with a realized loss to related parties who are non-spouses may have some benefit. If the property later increases in value, the basis for determining later gain is the original basis, increased by any gift tax paid. IRC §1015(d)(6). However, the basis for determining later loss is the basis at the time of the gift. IRC § 1015(a).

XXI. Marital Deduction

Planning for and preserving the marital deduction is an important ob-

jective. It is particularly important when the estate tax is in a state of flux, as is currently the case. By making a "QTIP" election, the Executor will enable the decedent's estate to claim a full marital deduction. A QTIP trust may be asset protected with respect to corpus; the income interest may be subject to claims of creditors.

To qualify, the trust must provide that the surviving spouse be entitled to all income, paid at least annually, and that no person may have the power, exercisable during the surviving spouse's life, to appoint the property to anyone other than the surviving spouse. Since the Executor may request a six month extension for filing the estate tax return, the Executor in effect has fifteen months in which to determine whether to make the QTIP election.

Where a QTIP election is made by the executor, the donor's estate takes the marital deduction. Normally, the surviving spouse is considered to be the transferor for GST tax purposes. However, the executor of the donor spouse may make a *second election* to treat the donor spouse as the transferor for GST tax purposes. IRC § 2652(a) (3). This is known as a "reverse QTIP" election.

Electing QTIP treatment is not always advantageous. Inclusion of trust assets in the estate of the first spouse to die may "equalize" the estates. Prior to 2011, equalization may have been desirable to avoid "wasting" the exemption amount of the first spouse. After 2010, this reason for equalizing estates is somewhat less compelling, since a surviving spouse may now claim the unused part of the predeceasing spouse's exemption amount. However, equalizing the estates may still be important, since remarriage by the surviving spouse will result in the loss predeceasing spouse's unused exemption amount.

Equalizing the estate may also have helped to avoid higher estate rate brackets that apply to large estates. Still, the savings in estate taxes occasioned by reason of avoiding the high-

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est tax brackets may itself be diminished by the time value of the money used to pay the estate tax at the first spouse's death. However, with the lower rate of estate tax, this factor is also now less compelling.

Another reason for not electing QTIP treatment would lie where the second spouse dies soon after the first. If no marital deduction is claimed in that case, a credit under IRC §2013 could operate to reduce the estate tax payable at the death of the surviving spouse.

An executor may elect QTIP treatment for only a portion of a trust qualifying for the QTIP election. The nonelected portion would be distributed in the same manner as the elected portion (since the trust terms do not change by virtue of the QTIP election). The only difference would be that the decedent's estate would receive no marital deduction, and the estate of the surviving spouse would not be required to include the assets in the estate of the surviving spouse upon that spouse's death.

If a partial QTIP election is anticipated, separating the trusts into one which is totally elected, and second which is totally nonelected, may be desirable. In this way, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse's estate.

Assets within a trust for which QTIP treatment has been elected will receive a step up in basis at death of the first spouse, and will receive a second basis step up at the time they are included in the estate of the surviving spouse. (This assumes that the decedent did not die in 2010 and his estate did not elect the carryover basis provisions.)

Assets in a trust which qualifies for a QTIP election but for which no election was made will receive a step up in basis at the death of the first spouse. Since those assets will not be included in the estate of the surviving

spouse, no basis step up will occur at the death of the surviving spouse, even if the trust terminates at that time. Therefore, electing QTIP treatment may be desirable if no estate tax is anticipated at the death of the surviving spouse, and the benefit of a basis step up exceeds the cost of any New York estate tax that might be occasioned by reason of the QTIP election.

QTIP property is included in the estate of the surviving spouse at its then fair market value. If estate tax liability arises, the estate of the surviving spouse is entitled to be reimbursed for estate tax paid from recipients of trust property. IRC § 2207A. Reimbursement is calculated using the highest marginal estate tax bracket of the surviving spouse. The failure to seek reimbursement may be treated by the IRS as gift made to those persons who would have been required to furnish reimbursement. However, the failure by the estate of the surviving spouse to seek reimbursement will not be treated as a gift if the Will of the surviving spouse expressly waives the right of reimbursement with respect to QTIP property.

Mistakes made when electing or funding QTIP trusts may sometimes be corrected. Section 9100 relief is available for failure to make a timely QTIP election on an estate tax return, since the deadline for making that election is prescribed by regulation (Treas. Reg. § 20.2056(b)-7(b)(4)(i)). Under Rev. Proc. 2001-38, an unnecessary QTIP election for a credit shelter trust will be disregarded to the extent it is not needed to eliminate estate tax at the death of the first spouse. Similarly, a mistaken overfunding of the QTIP trust will not cause inclusion of the overfunded amount in the estate of the surviving spouse. TAM 200223020.

Since the estate tax is a "tax inclusive," as opposed to the gift tax, which is "tax exclusive," there is a distinct tax benefit to making lifetime, as opposed to testamentary, transfers. Distributions from a QTIP trust can assist in accomplishing this objective.

A surviving spouse might make

gifts of income required to be distributed to the spouse. Even though the spouse is permitted to make gifts of distributed income, the trust may not require the surviving spouse to apply the distributed income to make gifts, as this would as this would constitute an impermissible limitation on the spouse's unqualified rights to income during his or her lifetime.

A surviving spouse's right to withdraw principal may also be used by the surviving spouse to make gifts. Treas. Reg. §20.2056(b)-7(d)(6) provides: "The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of IRC § 2956 (b)(7)(B)(ii)(II)." *Estate of Halpern v. Com'r*, T.C. Memo. 1995-352 also held that discretionary distributions made to the surviving spouse which were later used to make gifts would not result in inclusion in the estate of the surviving spouse.

The IRS has ruled that granting the surviving spouse a power to withdraw the greater of 5 percent of trust principal or \$5,000 per year (a "five and five" power) will not result in disqualification of QTIP treatment. However, if spouse were given an unlimited right to withdraw principal, the QTIP trust could morph into a general power of appointment trust. A full marital deduction is also allowed for a general power of appointment trust, so in this respect no tax detriment would ensue. However, the decedent's right to choose who would ultimately receive trust property would be defeated if the surviving spouse appointed all of the property during his or her lifetime.

If greater rights of withdrawal are given to the surviving spouse under an intended QTIP, but those rights did not rise to an unrestricted right to demand principal, the trust would be neither fish nor fowl. That is, the trust would constitute neither a general power of appointment trust nor a QTIP trust. This would result in a trust "meltdown" for estate tax purposes. The marital deduction would be lost

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and the entire trust would be brought back into the estate of the first spouse to die. The decedent's power to determine ultimate trust beneficiaries would be also be severely curtailed if not lose entirely.

To illustrate, assume at a time when the applicable exclusion amount is \$5 million, father has an estate of \$8 million, and mother has an estate of \$2 million. Father (who has made no lifetime gifts) wishes to give his four children \$6 million outright. If \$6 million were left to the children, \$1 million would be subject to federal estate tax, and \$5 million would be subject to New York estate tax. The total estate tax liability would be approximately \$1.15 million $[(\$1 \text{ million} \times .35) + (\$5 \text{ million} \times .16)]$.

This would leave the children with \$4.85 million of the \$6 million bequest. If instead of leaving \$6 million to the children outright, father were to leave only \$1 million to them outright, and place \$5 million in a trust qualifying for a QTIP election, federal and New York estate tax would be eliminated at father's death. If mother's estate were not to increase during her lifetime, no federal estate tax would be owed at her death, since her estate would not exceed the (combined) applicable exclusion amount of \$10 million.

If the surviving spouse made absolutely no taxable gifts during her lifetime, the New York State estate tax of \$800,000 deferred by the marital deduction ($\$5 \text{ million} \times .16$) would be payable upon her death by her estate. However, if the surviving spouse were to make gifts to the children during her lifetime, the eventual New York State estate tax could be diminished or even eliminated.

Consider the effect of the surviving spouse, would now be worth \$7 million, making gifts of \$0.25 million to each child per year for a few years. Each year, the surviving spouse would report a gift of \$1 million for federal gift tax purposes. Since the gift and estate taxes have been reunified, no gift

tax liability would arise for federal purposes.

Since New York State has no gift tax, no New York gift tax liability could arise by virtue of the gifts. Each year in which the surviving spouse made those gifts, the eventual New York estate tax liability would be reduced by approximately \$160,000. At the death of the surviving spouse, the trustee would distribute all of the remaining trust assets to the children, at a new stepped up basis.

Although this strategy appears sound for tax purposes, the surviving spouse must actually make the gifts contemplated. The cost of insuring against the risk of the surviving spouse not making the contemplated gift is the transfer tax savings resulting from the QTIP election. Any attempt to impose a legal obligation on the surviving spouse to make the annual gifts would destroy the QTIP, with potentially disastrous federal and New York state estate tax consequences.

This strategy would in most cases not lend itself well to second marriage situations, or to situations where the surviving spouse cannot be depended upon to make the contemplated annual gifts. Although these considerations do limit the utility of this strategy, the risk of the surviving spouse not making the gifts could conceivably be reduced to an acceptable level by leaving a sum of money to the children outright, and leaving some to the trustee of a QTIP trust.

Even if the spouse were willing to make gifts distributed principal, the ability to make those gifts depends upon the availability of principal. Principal may consist of land, interests in a closely held company, or other property that cannot easily be distributed. Even if principal distributions could otherwise be made, some QTIP trusts are not drafted so as to permit distributions of principal. Other trusts limit the Trustee's ability to make principal distributions. A QTIP trust is only required to provide for annual income distributions to the surviving spouse.

If the surviving spouse has no right to withdraw principal and the

trustee cannot make discretionary distributions of principal, gifting may still be possible if the surviving spouse releases or gifts all or part of the income interest of the surviving spouse. The gift by a surviving spouse of that spouse's qualifying income interest in the QTIP is a garden variety gift of that income interest under IRC §2511. However, the disposition could also trigger the draconian application of IRC §2519.

The "transfer of all interests" rule found in IRC §2519 applies to the release of the spouse's lifetime income interest. IRC §2519 provides that "any disposition of all or part of a qualifying income interest for life in any property to which this section applies is treated as a transfer of all interests in the property other than the qualifying income interest."

Therefore, if surviving spouse were wife to release or gifts one-half of his or her qualifying income interest, that spouse would be deemed to have disposed of all interests in that property. The gift of a qualifying income interest would result, for gift tax purposes, in the spouse reporting a gift of the entire remainder interest in the trust as well.

Fortunately, the "transfer of all interests" rule can be avoided by careful planning. The IRS has ruled that a taxpayer may sever QTIP trusts prior to the surviving spouse disposing of a partial income interest in the QTIP. This avoids the harshness of the "transfer of all interests" rule. See PLRs 200438028, 200328015.

To illustrate, assume the surviving spouse is 85 years old and releases his qualifying income interest in a trust worth \$1 million. Under the prevailing applicable federal rate (AFR) and using actuarial tables, the surviving spouse is deemed to have made a gift of \$180,000. For purposes of IRC §2511, the surviving spouse has made a taxable gift of \$180,000. For purposes of IRC §2519, the surviving spouse is deemed to have made a gift of \$820,000, *i.e.*, all interests in the property *other than* the qualifying income interest. Under IRC §2207A, the QTIP

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trust would have a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

Under IRC §2207A(a), a surviving spouse who is deemed to have made a gift of the remainder interest under IRC §2519, has a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

Proposed regulations provide for “net gift” treatment of the deemed gift of an interest under IRC §2519. (A net gift occurs if the donee is required, as a condition to receiving the gift, that he pay any gift taxes associated with the gift.) Since the value of what the donees receive is reduced by the gift tax required to be reimbursed to the surviving spouse, the amount of the gift reportable is also reduced by the amount reimbursed. The gift taxes so paid by the donee are deducted from the value of the transferred property to determine the donor’s gift tax.

Assume the value of the income and remainder interest in a QTIP trust is \$500,000. Spouse makes a gift of one-half of the income interest, or \$250,000. Under IRC §2519, spouse will be deemed to have made a gift of the entire \$500,000. If the gift tax rate were 50 percent, an interrelated calculation yields the result that a gift of \$333,333 would require gift tax of \$166,667. A gift of \$500,000 would therefore result in a “net gift” of \$333,333. The amount of the gift is reduced by the gift tax of \$166,667. This results in a net gift of \$333,333 to the beneficiaries.

Although releasing a qualifying income interest may be effective if the surviving spouse cannot withdraw principal and the trustee cannot make discretionary distributions of principal, spendthrift limitations in the Trust may prohibit the transfer of an income interest. An income beneficiary of a spendthrift trust generally cannot assign or alienate an income interest once accepted. See, e.g., *Hartsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark.

1989). If a spendthrift limitation bars the spouse from alienating the income interest, it may still be possible to disclaim the interest under New York’s disclaimer statute, EPTL 2-1.11.

Disclaimers may also be effective where after the death of the decedent, the surviving spouse determines that he or she does not require QTIP trust assets. Disclaiming the QTIP would accelerate the remainder beneficiaries’ interest in the QTIP trust.

However, there are problems associated with utilizing a disclaimer strategy with a QTIP. First, there are strict federal tax requirements that must be met. A “qualified disclaimer” for federal tax purposes must be made within nine months of the vesting of the interest. In addition, though the rule have been construed quite liberally, the disclaimant must not have accepted any of the benefits of the property to be disclaimed.

To constitute a qualified disclaimer under the Internal Revenue Code, the disclaimer must meet the requirements of state law, and it must be made within nine months. New York requires that the disclaimer be made within nine months, but the time period may be extended for “reasonable cause.”

If a New York Surrogate extended the time for reasonable cause, the renunciation would not constitute a qualified disclaimer under IRC §2519. Rather, the disclaimer would be a “nonqualified disclaimer.” While a “nonqualified” disclaimer might still be possible, such a disclaimer will be less attractive from a tax perspective. A nonqualified disclaimer could also trigger IRC §2519, since such a disclaimer would be ineffective for federal transfer tax purposes.

Assume the surviving spouse dies not having made any transfer or release of a QTIP interest during his or her lifetime. IRC §2044 requires that remaining QTIP assets be included in the gross estate of the surviving spouse. However, those assets are not aggregated with other assets in the estate of the surviving spouse.

Thus, in *Estate of Bonner v.*

U.S., 84 F.3d 196 (5th Cir. 1996) the surviving spouse at her death owned certain interests outright, and others were included in her estate pursuant to IRC §2044. The estate claimed a fractional interest discount, which the IRS challenged. The Fifth Circuit held that assets included in the decedent spouse’s gross estate which were held outright were not aggregated with those included under IRC §2044 by virtue of the QTIP trust. The estate was entitled to take a fractional interest discount. Apparently, even if the surviving spouse were a co-trustee of the QTIP trust, no aggregation would be required. See FSA 200119013.

Under *Bonner*, the issue arises as to whether the trustee of the QTIP trust may distribute a fractional share of real estate owned by the QTIP trust to generate a fractional interest discount at the death of the surviving spouse. It appears that this is possible. However, in *Bonner*, the surviving spouse owned an interest in certain property. Subsequently, she became the income beneficiary of a QTIP trust which was funded with interests in the same property. The surviving spouse in *Bonner* already owned a separate interest in the same property. This situation is distinguishable from one in which the QTIP trusts owns all of the interest in a certain piece of property, and then distributes some of that interest to the surviving spouse.

In that case, it is less clear that the estate would succeed in segregating interests in the same property for the purpose of establishing a valuation discount. The case would be weaker if the distribution of the fractional interest to the surviving spouse had, as one of its principal purposes, no purpose other than to support a later assertion of a fractional interest discount.

XXII. Disclaimers

Disclaimers can be useful in accomplishing post-mortem estate planning, since a person who disclaims property is treated as never having received the property for gift or estate or

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tax purposes under IRC § 2516. Although Wills frequently contain express language advising a beneficiary of a right to disclaim, such language is superfluous, since a beneficiary may always disclaim.

If the disclaimer meets the requirements of IRC § 2518, it will be a “qualified disclaimer” and the disclaimant will be treated as never having received the property. However, if the disclaimer is not qualified, the disclaimant will be treated as having received the property and then having made a taxable gift. Treas. Regs. §25.2518-1(b). Although the disclaimer statute appears in Chapter 11, the gift tax provisions of the Code, a disclaimer under IRC § 2516 is also effective for federal income tax purposes.

Under the EPTL, as well as under the laws of descent of most states, the disclaimant is treated as having predeceased the donor, or died before the date on which the transfer creating the interest was made. Neither New York nor Florida is among the ten states which have adopted the Uniform Disclaimer of Property Interests Act (UDPIA).

To constitute a qualified disclaimer under IRC § 2518, the disclaimer must meet the following requirements:

(i) The disclaimer must be irrevocable and unqualified. PLR 200234017 stated that a surviving spouse who had been granted a general power of appointment had not made a qualified disclaimer of that power by making a QTIP election on the estate tax return, since the estate tax return did not evidence an irrevocable and unqualified refusal to accept the general power of appointment.

(ii) The disclaimer must be in writing, identify the property disclaimed and be signed by the disclaimant or by his legal representative. Under EPTL § 2-1.11(f) the right to disclaim may be waived if in writing;

(iii) The disclaimer must be delivered to either the transferor or his

attorney, the holder of legal title, or the person in possession. Copies of the disclaimer must be filed with the surrogate court having jurisdiction of the estate. If the disclaimer concerns nontestamentary property, the disclaimer must be sent via certified mail to the trustee or other person holding legal title to, or who is in possession of, the disclaimed property;

(iv) The disclaimer must be made within nine months of the date of transfer or, if later, within nine months of the date when the disclaimant attains the age of 21. It is possible that a disclaimer might be effective under the EPTL, but not under the Internal Revenue Code. For example, under EPTL §2-1.11(a)(2) and (b)(2), the time for making a valid disclaimer may be extended until “the date of the event by which the beneficiary is ascertained,” which may be more than 9 months after the date of the transfer. In such a case, the disclaimer would be effective under New York law but would result in a taxable gift for purposes of federal tax law;

(v) The disclaimer must be made at a time when the disclaimant has not accepted the interest disclaimed or enjoyed any of its benefits. Consideration received in exchange for making a disclaimer would constitute a prohibited acceptance of benefits under EPTL §2-1.11(f); and

(vi) The disclaimer must be valid under state law, so that it passes to either the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer. EPTL §2-1.11(g) provides that a beneficiary may accept one disposition and renounce another, and may renounce a disposition in whole or in part. One must be careful to disclaim all interests, since the disclaimant may also have a right to receive the property by reason of being an heir at law, a residuary legatee or by other means. In this case, if the disclaimant does not effectively disclaim all of these rights, the disclaimer will not be a qualified disclaimer with respect to the portion of the disclaimed property which the dis-

claimant continues to have the right to receive. IRC §2518-2(e)(3).

(Note: An important exception to this rule exists where the disclaimant is the surviving spouse. In that case the disclaimed interest may pass to the surviving spouse even if she is the disclaimant. Treas. Reg. §25.2518-2(e); EPTL §2-1.11(e).)

IRC § 2518(c) provides for what is termed a “transfer disclaimer.” The statute provides that a written transfer that meets requirements similar to IRC § 2518(b)(2) (timing and delivery) and IRC § 2518(b)(3) (no acceptance) and which is to a person who would have received the property had the transferor made a qualified disclaimer, will be treated as a qualified disclaimer for purposes of IRC §2518. The usefulness of IRC § 2518 (c) becomes apparent in cases where federal tax law would permit a disclaimer, yet state law would not.

To illustrate, in *Estate of Lee*, 589 N.Y.S.2d 753 (Surr. Ct. 1992), the residuary beneficiary signed a disclaimer within nine months, but the attorney neglected to file it with the Surrogate Court. The beneficiary sought permission to file the late renunciation with the court, but was concerned that the failure to file within nine months would result in a nonqualified disclaimer for federal tax purposes.

The Surrogate Court accepted the late filing and opined (perhaps gratuitously, since the IRS is not bound by the decision of the Surrogate Court) that the transfer met the requirements of IRC § 2518(c). [Note that in the converse situation, eleven states, but not New York or Florida, provide that if a disclaimer is valid under IRC § 2518, then it is valid under state law.]

Treas. Reg. § 20.2055-2(c) provides that a charitable deduction is available for property passing directly to a charity by virtue of a qualified disclaimer. If the disclaimed property passes to a private foundation of which the disclaimant is an officer, he should resign, or at a minimum not have any power to direct the disposi-

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tion of the disclaimed property. The testator may wish to give family members discretion to disclaim property to a charity, but yet may not wish to name the charity as a residuary legatee. In this case, without specific language, the disclaimed property would not pass to the charity. To solve this problem, the will could provide that if the beneficiary disclaims certain property, the property would pass to the specified charity.

Many existing wills contain “formula” clauses which allocate to the credit shelter trust the maximum amount of money or property that can pass to beneficiaries (other than the surviving spouse) without the imposition of federal estate tax. If the applicable exclusion amount exceeds the value of the estate, the surviving spouse could be disinherited unless the beneficiaries of the credit shelter trust disclaim part of their interest. To the extent such interest is disclaimed and passes to the surviving spouse (either by the terms of the Will or by operation of law) it will qualify for the marital deduction.

Another use of the disclaimer in a similar situation is where either the surviving spouse renounces a power of appointment so that the trust will qualify as a QTIP trust. A surviving spouse who is granted a general power of appointment over property intended to qualify for the marital deduction under IRC § 2056(b)(5) may disclaim the general power, thereby enabling the executor to make a partial QTIP election. This ability to alter the amount of the marital deduction allows the executor to finely tune the credit shelter amount. If both spouses die within nine months of one another, a qualifying disclaimer by the estate of the surviving spouse can effect an equalization of estates, thereby reducing or avoiding estate tax.

Consider the effect of a qualified disclaimer executed within nine months by a surviving spouse of his lifetime right to income from a credit shelter trust providing for an outright distribution to the children upon his

death. If, within nine months of his spouse's death, the surviving spouse decides that he does not need distributions during his life from the credit shelter trust, and disclaims, he will be treated as if he predeceased his wife. If the will of the predeceasing wife provides for an outright distribution of the estate to the children if husband does not survive, then the disclaimer will have the effect of enabling the children to receive the property that would have funded the credit shelter trust at the death of the first spouse.

Disclaimers can also be utilized to increase basis in inherited assets by causing property that would otherwise pass by operation of law, to pass through a predeceasing spouse's estate. Assume surviving spouse paid no consideration for certain property held jointly with that spouse's predeceasing spouse. If second spouse disclaims within nine months, the property would pass through the predeceasing spouse's probate estate. If the Will provided for a residuary bequest to the surviving spouse, that spouse would inherit the disclaimed property with a full basis step up under the terms of the Will.

A qualifying disclaimer executed by the surviving spouse may also enable the predeceasing spouse to fully utilize the applicable exclusion amount. For example, assume the will of the predeceasing spouse leaves the entire estate of \$10 million to the surviving spouse (and nothing to the children). Although the marital deduction would eliminate any estate tax liability on the estate of the first spouse to die, the eventual estate of the surviving spouse would likely have an estate tax problem. By disclaiming \$5 million, the surviving spouse would create a taxable estate in the predeceasing spouse, which could then utilize the full applicable exclusion amount of \$5 million. The taxable estate of the surviving spouse would be reduced to \$5 million.

To refine this example, the will of the first spouse to die could provide that if the surviving spouse disclaims, the disclaimed amount would pass to a

family trust of which the surviving spouse has a lifetime income interest. The Will could further provide that if the spouse were also to disclaim her interest in the family trust, the disclaimed property would pass as if she had predeceased.

The grantor may wish to ensure that the named trustee will be liberal in making distributions to his children. By giving the child beneficiary the unrestricted right to remove the trustee, this objection can be achieved. However, if the child has the ability to remove the trustee, and the trust grants the trustee the power to make distributions to the child that are not subject to an ascertainable standard, the IRS may impute to the child a general power of appointment. If the IRS were successful, the entire trust could be included in the child's taxable estate. To avoid this result, the child could disclaim the power to remove the trustee. This might, of course, not accord with the child's nontax wishes.

If a surviving spouse is given a “five and five” power over a credit shelter or family trust, 5 percent of the value of the trust will be included in her estate under IRC §2041. However, if the surviving spouse disclaims within nine months, nothing will be included in his or her estate.

At times, all beneficiaries may agree that it would be better if no trust existed. If all current income trust beneficiaries (which might include the surviving spouse and children) disclaim, the trust may be eliminated. In such a case, the property could pass to the surviving spouse and the children outright. Note that if minor children are income beneficiaries, their disclaimers would require the appointment (and consent) of guardians *ad litem*.

Under New York law, if one disclaims, and by reason of such disclaimer that person would cause one to retain Medicaid eligibility, such disclaimer may be treated as an uncompensated transfer of assets equal to the value of any interest disclaimed. This, in turn, could impair Medicaid eligi-

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bility. In some states, if a disclaimer defeats the encumbrance or lien of a creditor, it may be alleged that the disclaimer constitutes a fraudulent transfer. Not so in New York and California, where a disclaimer may validly be utilized to defeat the legitimate claims of creditors. In Florida, the result is contra: A disclaimer cannot prevent a creditor from reaching the disclaimed property.

Until 1999, it had been unclear whether a qualified disclaimer could defeat the claim of the IRS. The 2nd Circuit in *United States v. Camparato*, 22 F.3d 455, cert. denied, 115 S.Ct. 481 (1994) held that it did not, finding that a federal tax lien attached to the "right to inherit" property. Therefore, a subsequent disclaimer did not affect the federal tax lien under IRC §6321. Resolving a split among the circuits, the Supreme Court, in *Drye v. United States*, 528 U.S. 49 (1999), adopted the view of the Second Circuit, finding that the federal tax lien attached to the property when created, and that any subsequent attempt to defeat the tax lien by disclaimer would not eliminate the lien.

Bankruptcy courts have generally reached the same result as in *Drye*. The disclaimer of a bequest within 180 days of the filing of a bankruptcy petition has in most bankruptcy courts been held to be a transfer which the trustee in bankruptcy can avoid. Many courts have held that even pre-petition disclaimers constitute fraudulent transfers which the bankruptcy trustee can avoid. If the *Drye* rationale were applied to bankruptcy cases, it would appear that pre-petition bankruptcy disclaimers would, in general, constitute transfers which the bankruptcy trustee could seek to avoid. However, at least one bankruptcy court, *Grassmuck, Inc., v. Nistler* (In re Nistler), 259 B.R. 723 (Bankr. D. Or. 2001) held that *Drye* relied on language in IRC §6321, and should be limited to tax liens.

The acceptance of benefits will preclude a disclaimer under state law.

EPTL §2-11(b)(2) provides that "a person accepts an interest in property if he voluntarily transfers or encumbers, or contracts to transfer or encumber all or part of such interest, or accepts delivery or payment of, or exercises control as beneficial owner over all or part thereof . . ."

Similarly, a qualified disclaimer for purposes of IRC § 2518(c) will not occur if the disclaimant has accepted the interest or any of its benefits prior to making the disclaimer. Treas. Regs. §25.2518-2(d)(1) elaborates, providing that actions "indicative" of acceptance include (i) using the property or interest in the property; (ii) accepting dividends, interest, or rents from the property; or (iii) directing others to act with respect to the property or interest in the property. However, merely taking title to property without accepting any benefits associated with ownership does not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). Nor will a disclaimant be considered to have accepted benefits merely because under local law title to property vests immediately in the disclaimant upon the death of the decedent. Treas. Regs. §25.2518-2(d)(1).

The acceptance of benefits of one interest in property will not, alone, constitute an acceptance of other separate interests created by the transferor and held by the disclaimant in the same property. Treas. Regs. §25.2518-2(d)(1). Thus, TAM 8619002 advised that a surviving spouse who accepted \$1.75x in benefits from a joint brokerage account effectively disclaimed the remainder since she had not accepted the benefits of the disclaimed portion which did not include the \$1.75x in benefits which she had accepted.

The disclaimant's continued use of property already owned is also not, without more, a bar to a qualifying disclaimer. Thus, a joint tenant who continues to reside in jointly held property will not be considered to have accepted the benefit of the property merely because she continued to reside in the property prior to effecting the disclaimer. Treas. Regs. §25.2518-2(d)(1); PLR 9733008.

The existence of an unexercised general power of appointment in a will before the death of the testator is not an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). However, if the powerholder dies having exercised the power, acceptance of benefits has occurred. TAM 8142008.

The receipt of consideration in exchange for exercising a disclaimer constitutes an acceptance of benefits. However, the mere possibility that a benefit will accrue to the disclaimant in the future is insufficient to constitute an acceptance. Treas. Regs. §25.2518-2(d)(1); TAM 8701001. Moreover, actions taken in a fiduciary capacity by a disclaimant to preserve the disclaimed property will not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(2).

A disclaimant may make a qualified disclaimer with respect to all or an undivided portion of a separate interest in property, even if the disclaimant has another interest in the same property. Thus, one could disclaim an income interest while retaining an interest in principal. PLR 200029048. So too, the right to remove a trustee was an interest separate from the right to receive principal or a lifetime special power of appointment. PLR 9329025. PLR 200127007 ruled that the waiver of the benefit conferred by right of recover under IRC §2207A constituted a qualified disclaimer.

A disclaimant makes a qualified disclaimer with respect to disclaimed property if the disclaimer relates to severable property. Treas. Regs. §25.2518-3(a)(1)(ii). Thus, (i) the disclaimer of a fractional interest in a residuary bequest was a qualified disclaimer (PLR 8326033); (ii) a disclaimer may be made of severable oil, gas and mineral rights (PLR 8326110); and (iii) a disclaimer of the portion of real estate needed to fund the obligation of the residuary estate to pay legacies, debts, funeral and administrative expenses, is a severable interest. PLR 8130127.

For disclaimants (other than a surviving spouse) who are residuary

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legatees or heirs at law, the disclaimant must be careful not only to disclaim the interest in the property itself, but also to disclaim the residuary interest. If not, the disclaimer will not be effective with respect to that portion of the interest which the disclaimant has the right to receive. §25.2518-2(e)(3). To illustrate, in PLR 8824003, a joint tenant (who was not a surviving spouse) was entitled to one-half of the residuary estate. The joint tenant disclaimed his interest in the joint tenancy, but did not disclaim his residuary interest. The result was that only half of the disclaimed interest qualified under IRC §2518. The half that passed to the disclaimant as a residuary legatee did not qualify.

The disclaimant may not have the power, either alone or in conjunction with another, to determine who will receive the disclaimed property, unless the power is subject to an ascertainable standard. However, with respect to a surviving spouse, the rule is more lenient. *Estate of Lassiter*, 80 T.C.M. (CCH) 541 (2000) held that Treas. Reg. §25.2518-2(e)(2) does not prohibit a surviving spouse from retaining a power to direct the beneficial enjoyment of the disclaimed property, even if the power is not limited by an ascertainable standard, provided the surviving spouse will ultimately be subject to estate or gift tax with respect to the disclaimed property.

An impermissible power of direction exists if the disclaimant has a power of appointment over a trust receiving the disclaimed property, or if the disclaimant is a fiduciary with respect to the disclaimed property. §25.2518-2(e)(3). However, mere precatory language not binding under state law as to who shall receive the disclaimed property will not constitute a prohibited "direction". PLR 9509003.

Limits on the power of a fiduciary to disclaim may have tax implications. PLR 8409024 stated that trustees could disclaim administrative powers the exercise of which did not

"enlarge or shift any of the beneficial interests in the trust." However, the trustees could not disclaim dispositive fiduciary powers which directly affected the beneficial interest involved. This rule limits the trustee's power to qualify a trust for a QTIP election.

In some states, representatives of minors, infants, or incompetents may disclaim without court approval. EPTL §2-1.11(c) permits renunciation on behalf of an infant, incompetent or minor. However such renunciation must be "authorized" by the court having jurisdiction of the estate of the minor, infant or incompetent. In *Estate of Azie*, 694 N.Y.S.2d 912 (Sur. Ct. 1999), two minor children were beneficiaries of a \$1 million life insurance policy of their deceased father. The mother, who was the guardian, proposed to disclaim \$50,000 of each child. The proposed disclaimer would fund a marital trust and would save \$40,000 in estate taxes. The Surrogate, disapproving the proposed disclaimer, stated that the disclaimer must be advantageous to the children, and not merely to the parent.

A disclaimer may be valid under the EPTL but not under the Code. EPTL §2-1.11(b)(2) provides that a renunciation must be filed with the Surrogates court within 9 months after the effective date of the disposition, but that this time may be extended for "reasonable cause." EPTL §2-1.11(a)(2)(C) provides that the effective date of the disposition of a future interest "shall be the date on which it becomes an estate in possession." Since under IRC §2518, a renunciation must be made within nine months, the grant of an extension by the Surrogates court of the time in which to file a renunciation might result in a valid disclaimer under the EPTL, but under federal tax law. Similarly, while the time for making a renunciation of a future interest may be extended under EPTL §2-1.11(a)(2)(C), such an extension would likely be ineffective for purposes of IRC §2518.

The rules for disclaiming jointly owned property can generally be divided into two categories. The first

category consists of joint bank, brokerage and other investment accounts where the transferor may unilaterally regain his contributions. With respect to these, the surviving co-tenant may disclaim within nine months of the transferor's death but, under the current EPTL, only to the extent that the survivor did not furnish consideration.

The second category comprises all other jointly held interests. With respect to all other interests held jointly with right of survivorship or as tenants by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation must be made no later than nine months after the creation.

A qualified disclaimer of an interest to which the disclaimant succeeds upon the death of another (*i.e.*, a survivorship interest) must be made no later than nine months after the death of the first tenant. This is true (i) regardless of the portion of the property contributed by the disclaimant; (ii) regardless of the portion of the property included in the decedent's gross estate under IRC §2040; and (iii) regardless of whether the property is unilaterally severable under local law.

A bill has been introduced in the New York legislature which would conform New York law to federal law. EPTL 2-1.11(b)(1) now provides that a surviving joint tenant or tenant by the entirety may not disclaim the portion of property allocable to amounts contributed by him with respect to such property. Under the proposed legislation, the surviving joint tenant or tenant by the entirety may disclaim to the extent that such interest could be the subject of a qualified disclaimer under IRC § 2518.

XXIII. Valuation Clauses

Transfer made by gift or by sale are frequently expressed by formula to avoid adverse gift tax consequences that could result if the value of the transferred interest were successfully challenged by the IRS on audit. There are two principal types of formula

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clauses: “value adjustment” clauses and “value definition” clauses.

A **value adjustment clause** provides for either an increase in the price of an asset or a return of a portion of the transferred asset to the donor if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this technique, which utilizes a condition subsequent to avoid a transfer in excess of that which is contemplated, is generally ineffective. A number of courts have ruled this would constitute a condition subsequent which would have the effect of undoing a portion of a gift. That would be against public policy and therefore void.

A **value definition clause** defines the value of the gift or sale at the time of the transfer. The agreement between the parties does not require a price adjustment or an adjustment in the amount of property transferred. The transaction is complete, but the extent of the property sold or given is not fully known at that time. An adjustment on a revaluation by the IRS will simply cause an adjustment of the interests allocated between the transferor and transferee(s). A value definition clause could allocate the transferred amount among non-taxable transferees, which could include charities, QTIP trusts, or outright transfers to spouses.

The Eighth Circuit, in *Estate of Christiansen*, approved the use of formula disclaimers. ___ F.3d ___, No. 08-3844, (11/13/09); 2009 WL 3789908, aff’g 130 T.C. 1 (2008). Helen Christiansen left her entire estate to her daughter, Christine, with a gift over to a charity to the extent Christine disclaimed her legacy. By reason of the difficulty in valuing limited partnership interests, Christine disclaimed that portion of the estate that exceeded \$6.35 million, as finally determined for estate tax purposes. Following IRS examination, the estate agreed to a higher value for the partnership interests. However, by reason of the disclaimer, this adjustment simply result-

ed in more property passing to the charity, with no increase in estate tax liability. The IRS objected to the formula disclaimer on public policy grounds, stating that fractional disclaimers provide a disincentive to audit.

In upholding the validity of the disclaimer, the Court of Appeals remarked that “we note that the Commissioner’s role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner’s role is to enforce the tax laws.” Although “savings clauses” had since *Com’r. v. Procter*, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944), rev’g and rem’g 2 TCM [CCH] 429 (1943) been held in extreme judicial disfavor on public policy grounds, carefully drawn defined value formula clauses have seen a remarkable rehabilitation. So much so that the Tax Court in *Christiansen* concluded that it “did not find it necessary to consider *Procter*, since the formula in question involved only the parties’ current estimates of value, and not values finally determined for gift or estate tax purposes.”

XXIV. New York Considerations

The mechanics of electing QTIP treatment are fairly simple. An election is made by completing Schedule M on the estate tax return. The executor Separate New York State QTIP Election. One New York State estate tax problem in connection with generously funding a QTIP was recently resolved by the New York State Department of Finance in a manner beneficial to New York residents.

XXV. Protective Claims

The executor may file a “protective claim” for refund, which would preserve the estate’s ultimate right to claim a deduction under IRC §2053(a). A timely filed protective claim would thus preserve the estate’s right to a refund if the amount of the liability is later determined and paid.

Although a protective claim would not be required to specify a dollar amount, it would be required to identify the outstanding claim that would be deductible if paid, and describe the contingencies delaying the determination of the liability or its actual payment. Attorney’s fees or executor’s commissions that have not been paid could be identified in a protective claim. Prop. Regs. §20.2053-1(a)(4).

A second limitation on deductible expenses also applies: Estate expenses are deductible by the executor only if approved by the state court whose decision follows state law, or established by a *bona fide* settlement agreement or a consent decree resulting from an arm’s length agreement. This requirement is apparently intended to prevent a deduction where a claim of doubtful merit was paid by the estate.

The proposed regulations suffer from some defects. To illustrate one, assume the will of the decedent dying in 2008 whose estate is worth \$10 million, designates that \$2 million should fund the credit shelter trust, with the remainder funding the marital trust. Assume also the existence of a \$3 million contested claim against the estate. If the executor sets apart \$3 million for the contested claim and files a protective claim for refund, the marital trust would be funded with only \$5 million, instead of \$8 million. If the claim is later defeated, the \$3 million held in reserve could no longer be used to fund the marital trust, and would be subject to estate tax.

Alternatively, the executor could simply fund the marital trust with \$8 million, not set aside the \$3 million, and not file a protective claim. If the claim is later determined to be valid, payment could be made from assets held in the marital trust. However, by proceeding in this manner, the IRS could later assert that the marital deduction was invalid.

Some have speculated that the existence of a large protective claim might also tempt the IRS to look more closely at other valuation issues in-

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volving other expenses claimed by the estate as a hedge against the possibility of a large future deduction by the estate.

XXVI. Partnerships and S Corporations

Income tax problems may arise if a nongrantor trust becomes the owner of S Corporation stock. In general, only certain trusts, *i.e.*, (i) grantor trusts; (ii) Qualified Subchapter S Trusts; and (iii) Electing Small Business Trusts may own S corporation stock. A grantor trust that becomes a nongrantor trust at the death of the grantor will no longer be an eligible S corporation shareholder. Without some affirmative action, the S corporation election would be lost, with attendant adverse income tax consequences. However, two remedies are available under which address this issue. The first involves the trust making an election to be treated as a "Qualified Subchapter S Trust," or "QSST".

To qualify as a QSST, IRC §1361(d)(3)(B) requires that trust instrument provide that all income be distributed annually to the sole trust beneficiary. An election must be made by the beneficiary to qualify the trust as a QSST. If the trust cannot qualify as a QSST because the trust instrument does not require all income to be distributed annually (*i.e.*, the trustee is given discretion to distribute income) it cannot qualify as a QSST.

Though less desirable, qualification for a nongrantor trust may still be possible by making an election to be treated as an Electing Small Business Trust, or "ESBT" under IRC §1361(e). In contrast to a QSST, an ESBT does not require that all income be distributed annually. The ESBT election is made by the trustee, rather than by the beneficiary. The ESBT, rather than the income beneficiary, will report his share of income from the S Corporation. Expenses of the trust will be allocated the Subchapter S interest of the Trust and the interest of the

Trust consisting of non-S Corporation assets.

Treas. Regs. § 1.1361-1(j)(6)(ii) (A) and IRC § 1.1361-1(m)(2)(iii) provide the time period in which an ESBT election must be made: if S Corporation stock is transferred to a trust, the [ESBT] election must be made within the 16-day-and-2-month period beginning on the day the stock is transferred to the trust.

When the Trust distributes income, the Trust will receive a deduction only for the portion of the distribution related to income derived from non-S Corporation trust assets. (This is in sharp contrast to the normal rules applicable to trust distributions to beneficiaries.) Therefore, to the extent a trust will not be entitled to receive any deduction. All income reported by the ESBT is taxed at the highest individual income tax rates. In addition, losses passed through from the S Corporation are not permitted to offset income from non-S Corporation assets held by the trust. See Treas. Regs. § 1.641(c)-1.

IRC § 1361(e)(3) and Treas. Regs. § 1.1361-1(m)(2) provide that the trustee must make the ESBT election. The election is made by signing and filing with the service center where the S Corporation files its returns a statement that meets the trust meets requirements of the regulations. If the trust has more than one trustee, each trustee must sign the election statement. The election statement must include the following information: (i) the name, address, and TIN of the trust; (ii) the potential current beneficiaries, and the S Corporations in which the trust owns stock; (iii) an identification of the election as an ESBT election made under Internal IRC § 1361(e)(2); (iv) the first date on which the trust owned stock in each S Corporation; (v) the date at which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and (vi) representations signed by the trustee stating that the trust meets the definitional requirements of IRC § 1361(e)(1) and all po-

tential current income beneficiaries of the trust meet the shareholder requirements of IRC § 1361(b)(1).

If a trust which has made an election to be treated as an ESBT or QSST terminates, the S corporation shares must be transferred to another qualifying shareholder to preserve the S Corporation election.

When a partner dies, the basis of any partnership interest passing to heirs is stepped up to fair market value. Until 2001, the partnership's inside basis in partnership assets remained the same following the death of a partner, and the transmission of the partnership interest to the decedent's heirs. However, IRC § 754, enacted in 2001, permits the partnership to increase (or decrease) the inside basis of partnership assets with respect to the interest of the deceased partner. This election will have the favorable result of permitting increasing the adjusted basis of partnership property to fair market value on the date of death of the decedent.

The heir will then be able to use the increased basis to report gain from the sale by the partnership of partnership property. The election will also be beneficial to the remaining partners since it will increase depreciation deductions, and reduce gain when the partnership ultimately disposes of the replacement property. The Section 754 adjustment will have no effect on other partners; therefore, the partnership will be required to keep two sets of books for the basis of partnership property. The election is made by the partnership on the return corresponding to the year in which the partner died. Although not irrevocable, the election may be only be revoked with the approval of the IRS.

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sired property but shift tax attributes.

Section 1031(f)(1) causes deferred realized gain to be recognized if, within 2 years, either related party disposes of exchange property, unless the disposition falls within one of three exceptions, the most important of which being that the exchange does not have as “one of the principal purposes” was tax avoidance. On the other hand, even if an exchange is outside the literal scope of the statute (*i.e.*, by engaging a QI) but was “structured” to avoid the related party rules, the entire exchange will fail under Section 1031 *ab initio*.

A “related person” is any person bearing a relationship to the taxpayer described in Sections 267(b) or 707(b)(1). Section 267(b) provides that related parties include (i) family members (spouses, siblings, ancestors, and lineal descendants); (ii) an individual and a corporation more than 50 percent of the value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (iii) two corporations which are members of the same controlled group; (iv) certain grantors, fiduciaries and beneficiaries of trusts; and (v) a corporation and a partnership if the same person owns more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or the profits interest in the partnership.

Section 267(c) provides for constructive ownership of stock. For example, Section 267(c)(1) provides that stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. Similarly, an individual is considered as owning stock owned, directly or indirectly, by or for his family. IRC § 267(c)(2).

Section 707(b)(1) provides that related parties include (i) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in such part-

nership; and (ii) two partnerships in which the same person owns, directly or indirectly, more than 50 percent of the capital interest or profits interest.

Section 1031(f)(1) establishes a 2-year holding period for property given or received in an exchange involving related persons. The holding period begins on the date of the last transfer constituting part of the related party exchange. (In a deferred exchange, the date of the last transfer may be up to 180 days after the transfer of the relinquished property.) If either related party “disposes” of property acquired in the exchange within two years of the initial exchange date, gain or loss deferred on the initial exchange will be recognized as of the date of the subsequent disposition.

To illustrate, Son owns Florida swampland with a basis of \$2 million, and a FMV of \$1 million. Father owns a fully depreciated Manhattan building with a basis of 0, and a FMV of \$1 million. Father and Son exchange the properties in an exchange qualifying for Father. Prior to Section 1031(f), Son could have sold the Manhattan property immediately after acquiring it and recognized a \$1 million loss, with Father’s \$1 million gain being deferred. The exchange would have had the effect of deferring recognition of Father’s gain, and accelerating Son’s \$1 loss. Section 1031(f) now requires Father to recognize deferred gain in the exchange if, within 2 years of the exchange, either Son or Father disposes of property acquired in the exchange. Therefore, if either Father or Son disposes of property acquired in the exchange after one year, deferral of Father’s gain will cease. IRC § 1031(f)(1)(C)(i),(ii); *see* PLR 200712013.

If either Father or Son dies within two years of the exchange, and a sale occurs by either Father or Son (or by either of their estates) of property acquired in the exchange, the related party rules will have no application. IRC § 1031(f)(2)(A).

Suppose that if instead of a direct exchange between Father and

Son, Father sold the building to a cash buyer through a qualified intermediary, and identified Son’s property as replacement property. In this case, there will have been no direct exchange between Father and Son. However, if IRS asserts that the exchange was motivated by tax avoidance, then the exchange treatment will be denied. *Teruya Brothers Ltd. v. Com’r*, 124 T.C. No. 4 (2005); *aff’d* 9th Cir. No. 05-73779 (Sept. 8, 2009); *Ocmulgee Fields v. Com’r* (T.C. No. 6 (2009); *aff’d* 11th Cir. No. 09-13395 (2010).

Had Son purchased the Florida swampland merely to accommodate Father’s desire to engage in an like kind exchange, and the transaction was not motivated by tax avoidance, then a disposition within two years by either Father or Son would not affect Father’s Section 1031 exchange treatment. §1031(f)(2)(C).PLR 200712013.

Prior to the enactment of the related party rules, in the above illustration, Father could have repurchased the Manhattan property from Son at fair market value and obtained a new depreciable basis. However, that strategy might have been challenged under the step transaction doctrine. *Court Holding Company v. Com’r*, 45-1 USTC ¶9215, 324 U.S. 331, 65 S.Ct. 707 (1945).

II. “Disposition” Defined

The term “disposition” is broad in scope and encompasses many transfers of property whether they be by sale, gift, contributions to an entity, or the granting of easements. The legislative history indicates that nonrecognition transfers involving carryover basis, such as those described in Sections 351, 721 or 1031 itself, do not constitute dispositions for the purpose of Section 1031(f)(1)(c)(ii). The granting of a lease should not be a disposition, provided the lease is a “true” lease. However, the term disposition does include an indirect disposition of property, such as that which occurs in

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connection with the transfer of corporate stock or a partnership interest. S. Rep. No. 56, 101st Cong., 1st Sess. 151-152 (1989).

Transfers to a grantor trust do not constitute a “disposition” within the meaning of Section 1031(f)(1)(c)(ii). PLR 9116009. However the transfer by a grantor trust to a third party or the termination of grantor trust status might be a disposition.

III. Excepted “Dispositions”

Under Section 1031(f)(2)(A)-(C), certain transactions, which would otherwise constitute “dispositions” for purposes of Section 1031(f)(1)(c)(ii), are excepted from the application of the related party rules. These exceptions are limited to dispositions which occur by reason of (i) the death of either related party; (ii) a compulsory or involuntary conversion under Section 1033 (if the exchange occurred before the threat or imminence of such conversion); or (iii) under Section 1031(f)(2)(C), a transaction with respect to which neither the exchange nor the disposition “had as one of its principal purposes the avoidance of federal income tax.” (The Conference Committee Report states that the exception is intended to apply to situations (i) that do not involve the shifting of basis between related taxpayers and to those (ii) that involve the partitioning of property between siblings which results in each taxpayer owning the entire interest in a single property.)

To illustrate, taxpayer enters into a safe harbor deferred exchange agreement with a qualified intermediary and transfers property to a cash buyer through the QI. A related party, who has no interest in pursuing a like kind exchange, acquires replacement property for cash. The taxpayer identifies that property as replacement property, and the second leg of the exchange proceeds through the QI. The related party merely facilitated the exchange. No tax avoidance purpose is present. Arguably, the related party

rules should be inapplicable here. PLR 200712013.

IV. Section 1031(f)(4) “Catch All”

Section 1031(f)(4) provides that like kind exchange treatment will not be accorded to any exchange that is a part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). One test used in determining whether the Section 1031(f)(4) “catch all” applies is to determine whether the related persons, as a group, have more cash after the related party transaction than before. If cash “leaves” the group, there is less chance that a tax avoidance motive is present. Conversely, if cash “enters” the group, a tax avoidance purpose is more likely.

The relationship is tested at the time of the exchange. If parties become “related” after the exchange, the related party rules presumably will not apply. Conversely, if the parties are related at the start of the exchange, the transaction will presumably be subject to the related party rules even if the parties are no longer related at the time of a disposition to which the subsection applies.

For example, assume the taxpayer were to exchange property with an S corporation owned by his brother. A year later brother sells all of his stock in the S corporation. Shortly thereafter, the S corporation sells the property originally acquired from the taxpayer. The sale by the S corporation would result in gain to the taxpayer, even though the taxpayer and the S corporation were no longer related at the time of the sale. With the same facts, the S corporation would also recognize gain if the taxpayer sold the property he originally acquired within the two-year period.

Field Service Advisory (FSA) 200137003 stated that the related party rules have no application after the 2-year period has elapsed, regardless of taxpayer motive. However, the “catch all” in § 1031(f)(4) warns that “[t]his section shall not apply to any exchange which is part of a transaction

(or series of transactions) structured to avoid the purposes of this subsection.” The word “section” refers to section 1031 itself, and not to subsection § 1031(f)(4). Therefore, a literal interpretation of the statute would seem to lead to the conclusion that like kind exchange treatment is not possible if § 1031(f)(4) is violated, regardless of whether two years elapses before a related party disposes of property acquired in the exchange.

Related party dispositions within 2 years may also trigger depreciation recapture. Section 1239 recharacterizes as ordinary income gain recognized on sales or exchanges between persons related under Sections 1239(a) or 707(b)(1) and (2). Since no gain is ordinarily recognized initially in a related party exchange, no ordinary income recapture would occur at the initial exchange if no boot is present. If boot is present, ordinary income recapture could occur, but not by reason of the related party rules, but rather by the application of Section 1239 itself.

If recharacterization under Section 1239 would otherwise have occurred at the time of the initial like kind exchange but for the fact that no boot is present, the IRS takes the position that a related party disposition within the proscribed period will trigger ordinary income recapture at the time of the later related party disposition. See PLR 8350084, 8646036, and Revenue Ruling 72-151.

May the taxpayer identify (within the 45-day identification period) and acquire replacement property from a related party as insurance against the possibility that other identified properties owned by unrelated parties cannot be acquired within the 180-day exchange period? Provided the taxpayer intended to close on the other properties, it seems as if the “no tax avoidance” exception of Section 1231(f)(2)(C) would be met in this circumstance.

V. Cases & Rulings Under §1031(f)

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In TAM 9748006, the taxpayer transferred property to an unrelated party through a qualified intermediary, and acquired his mother's property through a qualified intermediary as replacement property. The exchange violated Section 1031(f)(4), since the economic result of the series of transactions was identical to a direct exchange between the taxpayer and his mother, followed by her sale of the relinquished property. The TAM stated that an exchange structured through "a qualified intermediary is not entitled to better treatment than the related party referred to in the House Budget Committee Report."

In FSA 199931022, the taxpayer engaged a qualified intermediary to facilitate an exchange in which the taxpayer transferred property to an unrelated party and directed the QI to use the proceeds to acquire replacement property from a related party. The taxpayer's sale of the replacement property within two years of the exchange violated Section 1031(f)(4), since the replacement property had been acquired from a related party.

In Rev. Rul. 2002-83, the taxpayer's property was sold to an unrelated party through a QI. The QI acquired the related party's property for cash and transferred it to the taxpayer to complete the exchange. By using a QI, the taxpayer and the related party avoided a direct exchange. Citing Section 1031(f)(4), the ruling concluded that the engagement of a QI was part of a transaction structured to avoid the related party rules. The taxpayer was not entitled to nonrecognition treatment since, as part of the transaction, a related party received cash or other non-like kind property.⁴

In *Teruya Brothers Ltd. v. Com'r*, 124 T.C. No. 4 (2005), the Tax Court held that the transaction constituted a taxable sale rather than a deferred exchange, since it had been structured to avoid the purpose of Section 1031(f). *Teruya*, in a series of transactions, transferred several properties to a QI, who sold them to unre-

lated parties. The QI used the proceeds to purchase replacement properties from a corporation related to the taxpayer. Although the corporation recognized more gain on its sale than the taxpayer deferred, it had large net operating losses (NOL) which offset its gain. The Tax Court rejected the argument that the non-tax-avoidance exception of Section 1031(f)(2)(C) applied.

The Ninth Circuit in 2010 upheld the Tax Court's decision in *Teruya*. The Court of Appeals found that *Teruya* had "decreased their investment in real property by approximately \$13.4 million, and increased their cash position by the same amount. Therefore, *Teruya* had effectively "cashed out" of its investment. Noting that *Teruya* could have achieved the same property disposition through "far simpler means," the court observed that the transactions "took their peculiar structure for no purpose except to avoid § 1031(f). The presence of the QI, which ensured that *Teruya* was "technically exchanging properties with the qualified intermediary . . . served no purpose besides rendering simple – but tax disadvantageous – transactions more complex in order to avoid § 1031(f)'s restrictions." The exception found in § 1031(f)(2)(C) was inapplicable since "the improper avoidance of federal income tax was one of the principal purposes behind these exchanges." (No. 05-73779; 9/8/09).

In *Ocmulgee Fields*, the taxpayer transferred appreciated property to a qualified intermediary under an exchange agreement, whereupon the QI sold the same property to an unrelated party and used the sale proceeds to purchase like kind property from a related person that was transferred back to the taxpayer to complete the exchange. The IRS assessed a deficiency, arguing that the exchange was part of a series of transactions designed to avoid § 1031(f) and that the taxpayer had not established the "lack of tax avoidance" exception under § 1031(f)(2)(C). Citing *Teruya Bros., Ltd.*, the

Tax Court agreed with the IRS, noting that the immediate tax consequences resulting from the exchange would have reduced taxable gain by \$1.8 million, and would have resulted in the substitution of a 15 percent tax rate for a 34 percent tax rate. After *Ocmulgee*, and the Ninth Circuit decision in *Teruya*, it may be difficult to find a more likely than not basis to proceed with an exchange involving a related party in instances where the related party already owned the replacement property. The Tax Court came close to holding that basis shifting virtually precludes, as a matter of law, the absence of a principal purpose of tax avoidance.

The Eleventh Circuit affirmed the Tax Court, concluding that "the substantive result of *Ocmulgee Fields*' series of transactions supports an inference that *Ocmulgee Fields* structured its transactions to avoid the purposes of § 1031(f). . ." The court reasoned that even if *Ocmulgee* had not interposed a qualified intermediary, the transaction would fail because it could not establish the "lack of tax avoidance" exception in § 1031(f)(2)(C). The court found no "persuasive justification" for the complexity of its transaction other than one of "tax avoidance." Although *Ocmulgee* argued on appeal that tax avoidance was not a "principal purpose" of the exchange, the court found that the basis-shifting, reduction in immediate taxes, and shifting of the tax burden to the party with the lowest tax rate all justified negative "inferences" against the taxpayer. Finally, although *Ocmulgee* argued that it had a legitimate business purpose for the exchange, it failed to establish clear error. Moreover, the "mere existence of legitimate business purposes does not preclude a finding that *Ocmulgee Fields*' principal purpose for the exchange was tax avoidance." *Ocmulgee Fields, Inc., v. CIR*, No. 09-13395 (2010).

In PLR 200616005, Trust and S Corp. were related parties. Trust desired as replacement property a build-

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ing owned by S Corp. S Corp. intended to complete its own Section 1031 exchange. The Trust received some cash boot in its exchange. A qualified intermediary was used to accomplish the exchanges. The related party rules would not apply, provided the Trust and the S Corp. each held their respective replacement properties for at least two years. Section 1031(f) did not apply since neither party had “cashed out” of its investment.

In PLR 200706001, three siblings and a trust owned three tracts of timberland. One sibling wished to continue the timber investment, but the others wished to cash out. To achieve this result, one of the siblings exchanged her undivided 25 percent fractional interest in parcel 1 for a fee simple interest in parcel 3. Like kind exchange treatment was accorded pursuant to Rev. Rul. 73-476, which provides that an exchange of an undivided interest in real estate for 100 percent ownership of one or more parcels qualifies for exchange treatment. Although Section 1031(f) appeared to apply – the taxpayer exchanged her interest with a related party, and the related party then sold various parcels – the IRS concluded that since the transaction did not involve basis-shifting, the related party rules would not apply.

In PLR 200712013, a related party wished to acquire the taxpayer’s property (“Blackacre”). However, the related party owned no property which the taxpayer wished to acquire. A plan was devised whereby the taxpayer in step one would acquire replacement property (“Whiteacre”) in an exchange last reverse exchange. Accordingly, the taxpayer provided funds to the EAT, which acquired Whiteacre. The taxpayer and the related party entered into a contract for the sale of Blackacre for cash. The taxpayer identified Blackacre and assigned all rights in this contract to a QI. The QI transferred title in Blackacre to the related party for cash, which was transferred to the EAT. The EAT then direct

deeded title in Whiteacre to the taxpayer and extinguished the taxpayer’s debt, thus completing the reverse exchange.

The related party stated that it intended to dispose of Blackacre within two years. Ruling favorably, the IRS stated that Section 1031(f)(4) would not apply to this transaction, since the transfer of Blackacre to a related party was not part of a “transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1).” The related party did not own any property prior to the exchange. Therefore no basis shifting occurred, and the sale by the related party of Blackacre within two years would not trigger gain. An important aspect of this ruling was that the QI was not viewed as an agent of the taxpayer for purposes of applying Section 1031(f)(1).

In PLR 20091027, the taxpayer, the taxpayer’s sibling, and a trust were tenants in common of real property. The trustees of the trust wished to sell their interest in the real property. To increase the marketability of the interests sold, the three owners agreed to exchange each of their undivided 1/3 interests in the property for 100 percent fee simple interests in the same property. The proposed division would split the property into three parcels of equal value. The taxpayer sought a ruling regarding the applicability of IRC § 1031(f) to the proposed exchange. The ruling held that while the taxpayer and the taxpayer’s sibling were related, neither intended to sell their property within two years. Further, the taxpayer was not related to the trust within the meaning of IRC § 1031(f)(3); (*i.e.*, the trust did not bear a relationship to the taxpayer described in IRC §267(b) or 707(b)(1). Accordingly, the ruling stated that with respect to the taxpayer and the trust, there was no exchange between related persons for purposes of IRC §1031(f).

In CCM 20103038, the taxpayer, an auto dealer, attempted to structure a like kind exchange between it-

self and dealer, who were related parties under IRC § 267. Citing *Teruya Brothers, Ocmulgee Fields*, and Rev. Rul. 2002-83, IRS counsel concluded that the taxpayer “structured its transaction to achieve the impermissible result that Congress addressed in the legislative history.” It then concluded that the “no tax avoidance” exception of IRC §1031(f)(2)(C) was inapplicable, since qualification under the exception requires that tax avoidance not be “one” of its principal purposes. Therefore, even if other, non-tax avoidance purposes existed, the existence of any tax avoidance purpose would result in the inapplicability of the exclusion. The advisory concluded that

[a]s a matter of interpretation, the Service has consistently limited the §1031(f)(2)(C) exception to the situations Congress so specifically described in the legislative history. See Rev. Rul. 2002-83. We are not willing to expand the exception to cover the Taxpayer’s situation.

PLR 201027036 involved an exchange among a group of companies with a common parent. The ruling blessed the transaction. No direct exchange between the parties occurred by reason of the interposition of a qualified intermediary. Therefore, IRC § 1031(f)(1) was by its terms inapplicable. IRC § 1031(f)(4) was inapplicable since the related parties did not exchange high basis property for low basis property. Therefore, no “cashing out” occurred.

VI. Reporting Related Party Exchanges

Form 8824 (“Like Kind Exchanges”) requires the taxpayer to state (i) the name, relationship, and tax identification number of the related party; (ii) whether either the taxpayer or the related party sold (or disposed of) property acquired in the exchange within 2 years of the exchange date;

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and (iii) if the answer to (ii) was “yes”, whether the disposition qualified for an exception by reason of its being as a consequence of the death of either related party, or an involuntary conversion, or its being established “to the satisfaction of the IRS” by “written explanation” that neither the exchange nor the disposition had tax avoidance as one of its principal purposes.

The instructions add that indirect related party exchanges include (a) an exchange made with a related party through an intermediary (such as a QI or an EAT) or (b) an exchange made by a disregarded entity (*i.e.*, a single member LLC) if the taxpayer or a related party owns that entity. Form 8824 must be filed for two years following the taxable year of a related party exchange.

VII. Analysis for Related Party Exchanges

If a qualified intermediary is involved in the exchange, first consider the applicability of §1031(f)(4). If §1031(f)(4) is violated by a sale or disposition within two years, the result will be that the transaction will be recharacterized as a taxable sale *ab initio*, rather than a nontaxable exchange. In determining whether the (f)(4) “tax avoidance” provision will result in the transaction failing to constitute an exchange, the IRS looks at (i) basis shifting; (ii) cashing out; and (iii) tax avoidance.

If cash “leaves” the group, then the IRS is more likely to assert the applicability of Section 1031(f)(4). If the IRS finds that basis shifting, cashing out or tax avoidance motives are not present, then the existence of the QI may be favorable, since technically no related party exchange will have occurred. Therefore, an early “excepted” disposition (*i.e.*, a disposition within 2 years not having tax avoidance as a principal purpose), should not result in the application of the related party rules, and the denial of exchange treat-

ment.

Does the §1031(f)(4) taint remain with the exchange property even if the taxpayer (or the related party) waits 2 years before disposing of the exchange property? It is unclear whether the IRS could invoke §1031(f)(4) to disallow exchange treatment if the taxpayer possesses a tax avoidance motive, but waits two years before disposing of the exchange property. In both *Teruya* and *Ocmulgee*, the taxpayer disposed of the property within two years of the date of the exchange. One could argue that the related party rules have no application after two years. However, the counter argument would be that the two year rule applies to only *related party* exchanges.

By interposing a qualified intermediary, the exchange is no longer a related party exchange. Moreover, Section 1031(f)(4) provides that Section 1031 *itself* “shall not apply” to an exchange “structured to avoid the purposes” of the “this subsection” (*i.e.*, the related party rules). Since the statute of limitations on assessment is three years, it would seem prudent to consider waiting an extra year before disposing of any property acquired through a QI if the IRS could assert the existence of tax avoidance.

If 1031(f)(4) does not apply, then the two year holding period rule will be applicable to the exchange. For example, in PLR 200616005 both related parties (the trust and S Corp.) intended to engage in a Section 1031 exchange. However, if either party disposes of exchange property within two years, the related party rules will become operational, unless the sale or disposition is an “excepted” sale or disposition. Section 1031(f)(2) lists three statutory exceptions: (i) the death of either related party; (ii) an involuntary conversation; or (iii) the lack of a tax avoidance purpose for the exchange or the disposition.⁵ If a sale or disposition not falling within an exception occurs within two years, then deferred gain will be recognized at that time. However, unlike the situa-

tion arising where subsection (f)(4) takes the entire exchange out of Section 1031, here the exchange will be a good like kind exchange, but deferral will end at the date of the sale or other disposition.