

# TAX NEWS & COMMENT

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VOL. XX NO. 2

AUGUST 2011

NYTAXATTORNEY.COM

## IRS MATTERS

### VOLUNTARY REPORTING PROGRAM FOR FOREIGN ACCOUNTS ENDING AUGUST 31

#### 90-DAY "GOOD FAITH" EXTENSION AVAILABLE

Approximately one million U.S. taxpayers have at least one financial account located in a foreign country. Many have not reported their offshore accounts to the IRS, a violation with possible civil and criminal penalties. UBS, Switzerland's largest bank and the manager of private wealth for many Americans, is currently under investigation by the Department of Justice for not reporting interest and dividends earned by U.S. taxpayers.

The implementation of foreign account (FBAR) reporting requirements are provided for under the Bank Secrecy Act, enacted in 1970. The legislation was intended to assist  
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## FROM THE COURTS

### SUPREME COURT FINDS MEDICAL RESIDENTS NOT "STUDENTS" FOR PURPOSES OF FICA WITHHOLDING

The Supreme Court, in an unanimous opinion, held that a medical resident whose normal work schedule requires him to perform services 40 or more hours per week, is not a "student" for purposes of IRC § 3121(b), and therefore not within the statutory exception for FICA withholding. *Mayo Foundation For Medical Education v. United States*, No. 09-837 (2011).

*[The Federal Insurance Contributions Act (FICA) requires employees and employers to pay taxes on all "wages." FICA defines "employment" as "any service performed . . . by an employee for the person employing him," but excludes*  
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## FROM WASHINGTON

### ERA OF PREFERENTIAL CAPITAL GAINS RATES ENDING?

#### INCOME TAX RATES MAY DECREASE

With the debt crisis apparently averted, a bipartisan deficit-reduction panel is considering ending the preferential tax treatment of capital gains. Although not explicitly mentioned in the plan which is now being considered in the Senate, the proposal would end the tax preference for long term capital gains which has existed since 1986. However, individual and corporate income tax rates would also fall under the proposal.

In a five-page document recently obtained by Bloomberg News, the proposal would create three income tax brackets of between 23 percent and 29 percent, and would end the current preference for long term  
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### The Decedent's Last Will: A Final Profound Statement

#### I. Introduction

A will is a written declaration providing for the transfer of property at death. Although having legal significance during life, the will is without legal force until it "speaks" at death. Upon the death of the decedent, rights of named beneficiaries vest, and some obligations of named fiduciaries arise. However, the will cannot operate to dispose of estate assets until it has been formally admitted to probate. Historically a "will" referred to the  
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### Peering Through the Legal Prism: When Asset Protection Becomes Fraudulent

#### I. Introduction

English law addressing fraudulent conveyances dates back to the early Middle Ages. The first comprehensive attempt to prohibit such transfers appeared in the *Fraudulent Conveyances Act of 1571*, known as the "Statute of Elizabeth." The Act was promulgated by Elizabeth I, daughter of Henry VIII from his second marriage to the ill-fated Anne Boleyn. The statute forbade

feigned, covinous and fraudulent transfers of land and personalty en-  
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### AUGUST COMMENT Deferred Exchanges Under the Regulations

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

#### I. Overview of Statute

A deferred exchange may be a practical necessity if the cash buyer insists on closing before the taxpayer has identified replacement property. Recognizing the problem, *Starker v. U.S.*, 602 F.2d 1341 (9<sup>th</sup> Cir. 1979) articulated the proposition that simultaneity is not a requirement in a like kind exchange:

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## FROM WASHINGTON, CONT.

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capital gains, now taxed at 15 percent.

The deduction for home mortgage interest could also be affected. The mortgage interest deduction costs the Treasury about \$100 billion a year. Proposals have been made to either reduce the cap to \$500,000 or to eliminate the deduction on second homes.

If Congress fails to pass any new tax legislation in the next 18 months, the Bush tax cuts will expire on December 31, 2012. The Congressional Budget Office has warned that unless the Bush tax cuts are allowed to expire, a sharp increase in spending to fund President Obama's health care law will result in massive new debt. Grover Norquist, proponent of the "Americans for Tax Reform anti-tax pledge," recently stated that allowing the Bush tax cuts to expire as a means of closing the budget deficit would not constitute a tax increase or violate an anti-tax pledge signed by many Republicans.

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The Joint Committee on Taxation estimates that preferential long term capital gains tax rates cost the Treasury \$84.2 billion annually. More than 90 percent of the tax expenditure is enjoyed 20 percent of taxpayers; and half of the tax expenditure is enjoyed by the wealthiest 0.1 percent of taxpayers. For those taxpayers, increasing the long term gains tax rate to 29 percent, (the highest ordinary income tax rate under the proposal) would equate to a 93 percent increase in the current long term gains tax.

*An increase in the capital gains tax could adversely affect the performance of the stock market, which has seen a steady climb since the trough in early 2008. In the year to date, despite a lingering recession, a nuclear disaster, high energy prices, and a new European strain of persistently high unemployment, the Dow had continued to rise, until recently up 9.8 percent for the year, until recent events involving the debt crisis which have caused the Dow to lose more than half of that gain.*



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Former Governor Mitt Romney, a possible rival in 2012 to President Obama for the White House, has in the past advocated eliminating the capital gains tax on all individuals or families with less than \$200,000 of annual income. Mr. Romney also expressed support for elimination of the estate tax.

\* \* \*

Federal Reserve Chairman Ben Bernanke stated the central bank is examining several "untested means" to stimulate growth if conditions deteriorate, even though the central bank believes the recent economic downturn is temporary. The Fed recently completed a \$600 billion purchase of Treasury bonds completing "QE2." Addressing the Congress recently, Mr. Bernanke did not rule out further quantitative easing, noting "the possibility remains that the recent weakness may prove more persistent than expected and that deflationary risks might reemerge, implying additional policy support."

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## FROM WASHINGTON, CONT.

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While many expect the federal estate tax to become extinct in the next five to ten years, in many states not only is the estate tax not an endangered species, but in some states the estate tax has been enacted for the first time, and in other states, the tax has been increased. In New York, the estate tax exemption is firmly entrenched at \$1 million, an amount that has not changed since 2003. Illinois recently adopted an estate tax. Connecticut lowered its exemption amount from \$3.5 million to \$2 million. Fortunately, the rate of estate tax in New York is about 10 percent for estates less than \$6 million, and the maximum rate for much larger estates does not exceed 16 percent. It appears unlikely that Albany would increase the rate as that could risk the exodus of its wealthy retired residents.

Although the estate tax is imposed in 22 states, the tax pervades the Northeast and Midwest. Estate tax is imposed in every state in New England and the Mid-Atlantic, with the exception of New Hampshire, and in every state bordering a Great Lake, with the exception of Michigan and Ohio. Other states east of the Mississippi imposing the tax are Tennessee and Kentucky.

No southern state, with the exception of North Carolina, imposes an estate tax. West of the Mississippi, only Minnesota, Iowa, Nebraska, Washington and Oregon have an estate tax. Hawaii and Alaska have none.

The irony of the estate tax being most prevalent in states where few would choose to retire aside, many New Yorkers who divide their time between New York and the south or west are faced with the problem of limiting the time spent outside of New York to avoid income and estate tax. The Department of Taxation audits the time its subjects spend out of the state to ensure that Albany receives its tribute.

After a recent decision of the

Tax Appeal Tribunal, few out of state commuters will now likely purchase a vacation home in New York. (*See infra*, “From the Courts,” (*Matter of Barker*.) There does appear to be a real cost associated with the privilege of living — and after *Barker* not even living — but merely working and owning a vacation home, in the Empire State.

\* \* \*

While the federal estate tax exemption has risen substantially in the past few years, the federal gift tax exemption had remained constant for nearly a decade until a spike last year. In its haste to pass a tax bill in December of 2010, Congress unexpectedly increased the gift tax exemption to \$5 million from \$1 million. That increase is scheduled to “sunset” at the end of 2012. Many believe that there is good chance the gift tax exemption may decrease after sunset. For those who believe that Congress will decrease the \$5 million gift tax exemption and are otherwise inclined to make large gifts, now would appear to be a propitious time for doing so.

Not only would a donor be able to “lock in” the higher gift tax exemption amount, but the gift made by a New York resident would also reduce the size of the taxable estate at no tax cost, since New York has no gift tax. Although some have speculated that Congress could retroactively impose gift tax on large gifts if the federal exemption is lowered, this possibility appears remote.

Many had feared that Congress would retroactively install an estate tax for those dying in 2010, at a time when there was no estate tax in place. That fear proved unfounded. So too, it is unlikely that Congress would attempt to remove a benefit imposed on taxpayers merely taking advantage of substantial — even if temporary — gift tax exemption.

\* \* \*

President Obama in his 2012 budget proposal, has called for the re-

peal of LIFO, a method of computing net profit from sales of inventory. IRC § 472 permits taxpayers, with the approval of the IRS, to consider goods sold during the year to be those most recently acquired. When prices are rising, use of LIFO reduces taxable income. The proposal (which as supported by Senator McCain in 2008) would force taxpayers to convert to FIFO. Under FIFO, inventory is considered to be comprised of those goods which are earliest acquired. Those favoring repeal argue that LIFO allows unwarranted tax deferral and causes controversy between the taxpayer and the IRS. Opponents of LIFO repeal argue that taxing LIFO reserves is unfair since it taxes unrealized inflation-based profit.

\* \* \*

Two Senate democrats have urged the federal government to raise revenue by eliminating offshore “tax havens.” Senator Carl Levin of Michigan and Senator Kent Conrad of North Dakota have introduced a bill that would end current rules allowing hedge funds and corporations to avoid federal tax by opening overseas companies. According to Senator Levin, closing the loopholes could generate \$100 billion annually.

\* \* \*

On June 24, Governor Cuomo announced New York’s first property tax cap, which limits property tax levy increases to the lesser of 2 percent or the rate of inflation. The cap will take effect in the 2012 fiscal year for local governments and in 2012-13 for the school budget year. In a press release, Mr. Cuomo remarked: “We are beginning a new era in which New York will no longer be the tax capital of the nation . . . For too long, New Yorkers across the state have been forced to deal with back-breaking property taxes, and this cap will finally bring some relief and help keep families and businesses in New York. This tax cap is a critical step toward New York’s economic recovery, and will set our state on a path to prosperity.”



## FROM THE COURTS, CONT.

(Continued from page 1)

from taxation any “service performed in the employ of . . . A school, college or university . . . If such service is performed by a student who is enrolled and regularly attending classes [at the school]. IRC § 3121(b)(1).

Since 1951, the Treasury Department had construed the student exception to exempt from taxation students who work for their schools “as an incident to and for the purpose of pursuing a course of study.” 16 Fed. Reg. 12474. In 2004, the Treasury Department issued regulations providing that the services of a full time employee normally scheduled to work 40 or more hours per week “are not incident to and for the purpose of pursuing a course of study.” Treas. Regs. § 31.3121(b)(10)-2(d)(3)(iii). The regulations stated that the analysis was not affected by “the fact that the services . . . may have an educational, instructional, or training aspect. *Id.*”

Mayo paid the FICA tax, and filed suit for refund in District Court claiming that the rule was invalid. The District Court granted summary judgment for Mayo, finding that the regulation was inconsistent with the unambiguous words of the statute. However, the Eighth Circuit reversed, finding that the regulation was a permissible interpretation of an ambiguous statute. The Supreme Court granted Certiorari and, in an opinion by Chief Justice Roberts, affirmed the decision of the Eighth Circuit.]

The Court began its analysis by noting that the regulation in question provides that an employee’s service is “incident” to his studies only when “[t]he educational aspect of the relationship between the employer and the employee, as compared to the service aspect of the relationship, [is] predominant.” Treas. Reg. § 31.3121(b)(10)-(d)(3)(i).

The Court cited to *Chevron U.S.A. v. National Resources Defense Counsel, Inc.*, 467 U.S. 837 (1984), in finding relevant the inquiry as to whether Congress had “directly addressed the precise question at issue.”

The Court found that Congress had not, since the statute does not define the term “student,” and does not address the question of whether medical students are subject to FICA.

The Court found unpersuasive Mayo’s argument that the dictionary definition of “student” as one “who engages in ‘study’ by applying the mind ‘to the acquisition of learning, whether by means of books, observations, or experiment’ plainly encompasses residents, since a “full-time professor taking evening classes” could fall within the exemption.

Moreover, the Court was unimpressed with the view of the District Court that an employee be deemed a ‘student’ as long as the educational aspect of his service “predominates over the service aspect of the relationship with his employer,” dryly observing that “[w]e do not think it possible to glean so much from the little that § 3121 provides.” The Court concluded that neither the plain terms of the statute, nor the District Court’s interpretation of the exemption “speak[s] with the precision necessary to say definitively whether [the statute] applies to medical students.”

The Court then to cited *Chevron* with approval:

*Chevron* recognized that the power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.

The regulations at issue were promulgated pursuant to the “explicit” authorization granted to the Treasury by Congress to “prescribe all needful rules and regulations for the enforcement of” the Internal Revenue Code. IRC § 7805(a). Finding that Treasury had issued the full time employee rule only after notice-and-comment procedures, the rule “merits *Chevron* deference.” *Long Island Care at Home, Ltd., v. Coke*, 551 U.S. 158, 173-174 (2007).

The Court then addressed Mayo’s argument that the Treasury

Department’s conclusion that residents who work more than 40 hours per week “categorically cannot satisfy” the student exemption.

The Court first found “perfectly sensible” the Treasury Department’s method of distinguishing between workers who study and students who work was by “[f]ocusing on hours an individual works and the hours he spends in studies.” The approach, the Court noted, avoids “wasteful litigation and needless uncertainty” and, as Treasury observed, “improves administrability.”

The Court then observed that taxing residents under FICA would “further the purpose of the Social Security Act . . . and import a breadth of coverage.” Although Mayo contended that medical residents have not yet “begun their working lives because they are not fully trained,” Treasury had not acted “irrationally” in concluding that “these doctors — ‘who work long hours, serve as highly skilled professionals, and typically share some or all of the terms of employment of career employees’ — are the kind of workers that Congress intended to both contribute to and benefit from the Social Security system. 69 Fed. Reg. 8608.” As a *coup de grace*, the Court, citing *Bingler v. Johnson*, 394 U.S. 741, 752 (1969) for the proposition that “exemptions from taxation are to be narrowly construed.”

Recognizing the value medical residents impart to society, Chief Justice Roberts concluded the opinion by observing:

We do not doubt that Mayo’s residents are engaged in a valuable educational pursuit or that they are students of their craft. The question whether they are “students” for purposes of §3121, however, is a different matter. Because it is one to which Congress has not directly spoken, and because the Treasury Department’s rule is a reasonable construction of what Congress has said, the judgment of the Court of Appeals must be affirmed.

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## FROM THE COURTS, CONT.

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The IRS has advanced many theories to challenge the gift and estate tax savings occasioned by the use of family entities and grantor trusts in estate planning. Most arguments have been unsuccessful. However, the IRS discovered a potent weapon in IRC § 2036(a), which provides that the value of the gross estate includes the value of all property to the extent the decedent has made a transfer but has retained (i) the possession or enjoyment of, or the right to income from, the property, or (ii) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The IRS has been successful in arguing that IRC § 2036(a) requires the inclusion in the decedent's estate of (i) partnership assets if the decedent continued to derive benefits from the partnership, or of (ii) trust assets, if the decedent continued to receive distributions. The IRS has been most successful where the transactions with not imbued with a sufficient quantum of non-tax objectives, or the economics of the transaction were questionable, most often because the transferor had not retained sufficient assets to live according to his accustomed standard without receiving partnership (or trust) distributions.

The Ninth Circuit recently affirmed a decision of the Tax Court which found that the decedent's retention of benefits in property transferred to a partnership resulted in the failure of the transfer to constitute a bona fide sale for full and adequate consideration. *Estate of Jorgensen v. Com'r*, No. 09-73250 (5/11/11). On appeal, the Estate did not contest that the decedent had retained some of the benefits of the transferred property, but argued that the benefits retained were *de minimis*. The Ninth Circuit disagreed, remarking:

We do not find it *de minimis* that decedent personally wrote over \$90,000 in checks on the accounts post-transfer, and the partnerships paid over \$200,000 of her personal estate taxes from partnership funds. See *Strangi v. Com'r*, 417 F.3d 468, 477 (5th Cir. 2005) (post-death payment of funeral expenses and debts from partnership funds indicative of implicit agreement that transferor would retain enjoyment of property); see also *Bigelow*, 503 F.3d at 966 (noting payment of funeral expenses by partnership as supporting reasonable inference decedent had implied agreement she could access funds as needed).

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## By Rebecca K. Richards

The Court of Appeals for the District of Columbia Circuit in *Intermountain Insurance Service of Vail, LLC v. Com'r*, reversed the Tax Court and upheld an IRS regulation that considered an overstatement of basis as an "omission of gross income" for the purpose of triggering the extended six-year statute of limitations provided for in Internal Revenue Code sections 6501(e)(1)(A) and 6229(c)(2). 2011 WL 2451011 (D.C. Cir. June 21, 2011).

*[In general, under IRC § 6501(a), the IRS has three years to make an adjustment to the amount of gross income reported by a taxpayer. However, IRC § 6501(e)(1)(A) extends the statute of limitations to six years when the taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 percent of gross income stated in the return." IRC § 6229(c)(2) provides for an extended six-year statute of limitations under a similar statutory scheme for partnerships.]*

*On its 1999 income tax return, Intermountain reported a loss on the sale of assets. On September 14, 2006, nearly six years later, the IRS issued a deficiency alleging that Intermountain had realized a gain of approximately \$2 million on its 1999 sale of assets. The IRS alleged that Intermountain had overstated its basis and, therefore, understated its gross income.*

*In response, Intermountain filed*

*a motion for summary judgment in the Tax Court, arguing that the adjustment was not timely since it was not within the three-year statute of limitations. In opposition, the Commissioner argued that the adjustment was timely because the 1999 return contained an "omission from gross income," thus triggering the extended six-year statute of limitations provided for in §§ 6501(e)(1)(A) and 6229(c)(2).]*

In reliance on the Supreme Court decision in *Colony, Inc. v. Com'r*, 357 U.S. 29 (1958), the Tax Court granted summary judgment to Intermountain and held that an overstatement of basis did not constitute an "omission from gross income" for the purpose of IRC §§ 6501(e)(1)(A) or 6229(c)(2). The Supreme Court held in *Colony* that basis overstatements did not constitute "omissions from gross income" for the purpose of the predecessor to IRC § 6501(e)(1)(A). The Tax Court found *Colony* to be controlling authority and ruled that the extended statute of limitations did not apply.

Shortly thereafter, the IRS issued regulations contradicting the Tax Court's ruling. The regulation stated that the phrase, "omits from gross income," in IRC §§ 6501(e)(1)(A) and 6229(c)(2) generally included overstatements of basis. The Commissioner then moved the Tax Court for reconsideration. The Tax Court denied the motion, finding the regulation inapplicable because it had not become effective until after the three-year statute of limitations had expired. The Commissioner then appealed to the Court of Appeals for the District of Columbia Circuit.

The issue posed to the Court of Appeals was whether to afford deference to the IRS regulation interpreting IRC §§ 6501(e)(1)(A) and 6229(c)(2) as including basis overstatements in the definition of "omission from gross income." The Court found that IRC § 6501(e)(1)(A) was indeed ambiguous because "neither the section's structure nor its legislative history nor the context in which it was passed" clearly resolved the question of whether an

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## FROM THE COURTS, CONT.

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overstatement of basis constituted an omission from gross income. *Intermountain*, 2011 WL 2451011 at \*12.

In performing the *Chevron* analysis, i.e., whether the regulation is a reasonable interpretation of the statute, the Court found “nothing unreasonable” in the IRS regulation interpreting “omits from gross income” as including overstatements of basis. Accordingly, the Court found that the regulation was entitled to deference.

Legislative regulations interpret statutes that expressly delegate the authority to promulgate regulations. Interpretative regulations are less authoritative and are used primarily to interpret the Code. The regulations at issue in *Intermountain* were interpretative regulations. *Intermountain* illustrates the high level of judicial deference that is afforded to agency regulations under *Chevron*.

Deferring to agency regulations is in seeming opposition to the long-standing concept of *staré decisis* (judicial obligation to respect precedents established by prior cases). However, with administrative agencies such as the IRS, the Supreme Court has stated that some flexibility may be desirable: “To engage in informed rulemaking, [the agency] must consider varying interpretations and the wisdom of its policy on a continuing basis.” *Chevron*, 467 U.S. at 863-64.

*[Rebecca is entering her third year at Hofstra Law School, where she is at the top of her class. Rebecca is Senior Articles Editor for the Journal of International Business and Law. She expects to graduate in May, 2012. Rebecca is completing a productive seven-month internship at the office.]*

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The Tax Appeals Tribunal has affirmed a Determination of the Division of Tax Appeals which found that a Connecticut domiciliary who commuted to Manhattan as an investment

manager was subject to New York State personal income tax on income from all sources, and not merely their New York source income, under Tax Law § 601 as a “resident individual” solely by reason of ownership of a summer house near Amagansett which was sporadically used. *In the Matter of John and Laura Barker*, DTA No. 822324.

Tax Law § 605(b)(1) includes in the definition of a “resident individual” a person “who is not domiciled in this state but maintains a permanent place of abode in this state and spends in the aggregate more than one hundred and eighty-three days of the taxable year in this state. . .” The taxpayer conceded that he spent more than the required 183 days in New York. At issue was whether the summer house constituted a “permanent place of abode” for the purpose of Section 605(b)(1). Administrative Law Judge Joseph Pinto, after a hearing at the Division of Tax Appeals found that it did, and upheld a \$1.056 million deficiency (consisting of tax, interest and penalties) resulting from a three-year audit beginning in 2002.

On appeal, the taxpayer argued that the ALJ had misconstrued the “permanent place of abode” analysis and had incorrectly found the summer house not to be a “camp or cottage”. The Tax Appeals Tribunal began its analysis by noting that only the regulations (and not the statute) defines the term “permanent place of abode.” Under 20 NYCRR 105.20(e), the term was defined as “a dwelling place permanently maintained by the taxpayer. . . [but not] a mere camp or cottage.”

The taxpayer argued that the vacation home was not a permanent place of abode, citing an earlier case which it interpreted as establishing a “subjective standard” providing that the permanence “must encompass the physical aspects of the dwelling place as well as the individual’s relationship to the place.” The Tribunal dismissed this argument, stating that the holding stood only for the proposition that a permanent place of abode may be found even where the taxpayer bears no legal right to the property.

The Tribunal rejected the taxpayer’s argument that the subjective use of the summer house was determinative, stating that “[it] is well settled that a dwelling is a permanent place of abode where, as it is here, the residence is objectively suitable for year round living and the taxpayer maintains dominion and control over the building.” The only positive note for the taxpayer in the case is that the Tribunal remanded the matter to the ALJ for a supplemental determination as to whether the petitioners had established reasonable cause for abatement of the \$221,086 in penalties.

The upshot of this case is that working in New York will be enough to subject all of a person’s income to New York income tax if the person owns a vacation home in New York, without regard to whether the home is used. The ruling may well discourage nonresidents from owning a summer home in New York.

The interpretation of the regulations by the Division of Tax Appeals and the Tax Appeals Tribunal is not without legitimate disagreement. The phrase in the regulations which excludes a “mere camp or cottage, which is suitable and used only for vacations” taken literally certainly justifies those Tribunals’ view that the exception is inapplicable. However, one is left with the distinct impression when reading the first sentence of the regulation, that the phrase “a dwelling place permanently maintained by the taxpayer” is not satisfied where the taxpayer owns summer home in which the taxpayer does not spend much time since, at least with respect to the taxpayer, it is not the taxpayer’s “dwelling place.”

Furthermore, an elementary cannon of statutory construction provides that where the words of the statute are clear, there is no need to consult the regulations. Admittedly, in the case, the statute failed to define the term “permanent place of abode.” However, the interpretation of the regulation by the Tribunals seems to contradict the statute, since the statutory phrase “permanent place of abode”

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cannot seemingly be satisfied by a taxpayer who does not reside in that abode.

For example, assume that the statute had imposed tax on “dogs”. The regulations define the term “dogs” as “including cats.” Clearly a cat is not a dog. Yet under these regulations cats would be taxed. The regulations contradict the statute, which is clear. Should a deficiency attempting to impose tax on a cat be upheld? This analogy is not intended to suggest that the case in issue presented such a stark situation. However, the analogy is fair.

Although it will be too late for this taxpayer, should the legislature feels that the result is not what it intended, it could revise the statute or regulations. Whether or not this is the result the legislature intended, one suspects that Albany may not act. Therefore, commuters who own a vacation residence in New York should be aware that they must report all of their income, from whatever source, on their New York State income tax return.

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The Tax Appeals Tribunal, affirming a determination of the Administrative Law Judge, has found that Madagascar has no right to claim a refund for transfer tax paid in connection with the sale of its New York City mission. *In the Matter of The Republic of Madagascar*, DTS Nos. 822357 and 822358.

There was no dispute that the condominium housed the “premises of the mission” under the Vienna Convention on Diplomatic Relations of 1961. Accordingly, Madagascar was exempt from liability for transfer tax. However, as part of the negotiations for the sale of the mission, Madagascar agreed to pay half of the transfer tax. Normally, the transfer tax is the responsibility of the seller. The problem with the arrangement was that Madagascar paid the tax *on behalf of*

the purchaser. Tax Law § 1404[b] provides that while the grantor is generally responsible for the payment of transfer tax, where the grantor is exempt, the liability for payment of the tax shifts to the grantee.

In finding “no remedy” under the Tax Law for Madagascar, the Tribunal observed:

[T]he State of New York did not impose any tax liability upon petitioner in this case. . . . Petitioner’s obligation to pay resulted from volunteering to do so as part of its contractual agreements. . . . The Vienna Convention does not affect petitioner’s liability under the Tax Law since it was the terms of the parties’ contracts that resulted in petitioner paying the transfer tax at issue.

\* \* \*

In general, expenses paid during the taxable year for medical care of the taxpayer or a dependent not compensated for by insurance or otherwise may be deducted to the extent those expenses exceed 7.5 percent of AGI under IRC § 213. The term “medical care” includes “amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and amounts paid for qualified long-term care services.” Long term care expenses are deductible if a physician has determined that the taxpayer is “chronically ill.”

The Tax Court, in *Estate of Baral v. Com’r*, No. 3618; 7/5/2011, found that payments made to caregivers were deductible as itemized medical expenses (subject to the 7.5 percent AGI limitation) since a physician had determined that the taxpayer, who suffered from dementia, was chronically ill. Although the payments were not made to medical personnel, they were nevertheless deductible as “medical expenses” since a physician had found the services necessary due to the taxpayer’s dementia, and had recommended 24-hour care.

A contrary result was reached by the Tax Court in *Estate of Olivio v. Com’r*, (No. 15428-07; 7/11/2011). In *Olivio*, a child provided long-term care

for nine years, and claimed as a debt of his mother’s estate \$1.24 million, representing the value of the services allegedly provided by him pursuant to an oral agreement with his mother. he Tax Court found that services provided by family members are presumed to be without remuneration in the absence of a written agreement.

## IRS MATTERS, CONT.

(Continued from page 1)

U.S. investigators in preventing offshore tax evasion and in tracing funds used for illicit purposes, such as the laundering of drug money. Actual reporting of foreign accounts and the filing of FBARs has been required since 1972, but the rule was largely ignored by taxpayers and rarely enforced by the IRS until recently.

FBAR regulations were recently amended and became effective March 28, 2011. The amended regulations apply to all foreign financial accounts maintained in the year 2010. 31 C.F.R. § 1010.350 now provides that “each United States person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country” must file a Foreign Bank and Financial Accounts Report (FBAR).

A “United States person” includes U.S. citizens and residents, and domestic corporations, partnerships, estates, and trusts. Having “signature authority” over a foreign financial account means that the person can control the disposition of money in the account by sending a signed document to, or orally communicating with, the institution maintaining the account.

31 C.F.R. § 1010.306(c) provides that an FBAR must be filed if the aggregate value of *all* foreign financial accounts is more than \$10,000 at any time during the calendar year. To illustrate, if a U.S. person owns several small financial accounts in various countries, that person will be required to file an FBAR if the value of all the accounts exceeds \$10,000 at any time during the calendar year. There are some exceptions to the FBAR filing requirement, such as if the offshore financial account is owned by a government entity or if the person is a trust beneficiary.

31 C.F.R. § 1010.306(c) provides that the FBAR must be filed by June 30 for foreign financial accounts exceeding \$10,000 during the previous calendar year on Treasury Form TD F90-22.1. The FBAR is not filed with income tax returns, but must be report-

ed on income tax returns by checking the appropriate box on Schedule B of Form 1040, which requires the taxpayer to disclose the existence of a foreign bank account. Notice 2011-54 provides that persons having signatory authority over, but no financial interest in, a foreign financial account in 2009 or earlier calendar years are required to file FBARS by November 1, 2011.

Extensions given by the IRS for income tax returns are not applicable to the FBAR filing deadline. FBAR reporting is an effective tool for the IRS, because the Treasury need show only that the taxpayer maintained an unreported overseas account, not whether the taxpayer actually earned any income from the account.

Due to increased efforts by the IRS to penalize U.S. taxpayers with undisclosed offshore accounts, and in an attempt to persuade those taxpayers into reporting those accounts, the IRS initiated the 2011 Offshore Voluntary Disclosure Initiative (“OVDI”) on February 8, 2011. The OVDI is the second program of its kind. The first voluntary disclosure program, the 2009 Offshore Voluntary Disclosure Program (“OVDP”), terminated on October 15, 2009 with approximately 15,000 voluntary disclosures.

### **Procedure for OVDI Participation**

The OVDI allows taxpayers with undisclosed foreign accounts to report their accounts and to come into compliance with the U.S. tax system without risking later detection by the IRS. Taxpayers with undisclosed offshore accounts could face the imposition of high penalties and the possibility of criminal prosecution if the accounts are later discovered by the IRS. Taxpayers who willfully fail to file FBARs face criminal penalties of up to \$500,000 or fifty percent (50%) of the account balance and imprisonment of up to ten years, and civil penalties of up to \$100,000 or fifty percent (50%) of the account balance.

The lifespan of the OVDI program is short. The OVDI program is available to taxpayers only through

August 31, 2011. The program requires that participants pay a penalty of twenty-five percent (25%) of the highest account balance between 2003 and 2010, but provides exceptions that could reduce the penalty to five percent (5%) or twelve-and-a-half percent (12.5%).

Participants must also file all original and amended tax returns and pay back taxes and interest, as well as accuracy-related and/or delinquency penalties. Initially, the IRS required that all forms and payments be submitted by August 31, 2011. However, on June 2, 2011, the IRS revised the program to allow a 90-day extension if the requesting taxpayer demonstrates a “good faith attempt” to meet the August 31 deadline. If making such a request, the taxpayer must include a list of those items which are missing, an explanation for why they are still outstanding, and a description of the efforts made to secure them.

To participate in the program, a taxpayer has the option of submitting a “pre-clearance request” to the IRS Criminal Investigation Lead Development Center. The submission must be made by fax to (215) 861-3050, and must include the taxpayer’s name, date of birth, social security number and address and, if the taxpayer is represented by an attorney or accountant, an executed power of attorney.

The IRS Criminal Investigation office will notify the taxpayer or the taxpayer’s representative via fax whether the taxpayer has been cleared to make a voluntary disclosure using the Voluntary Offshore Disclosure Letter. Taxpayers or representatives with questions may contact either their local IRS Criminal Investigations office or the Washington office at (215) 861-3759. If cleared by IRS Criminal Investigations, the taxpayer will have 30 days in which to submit an “Offshore Voluntary Disclosure Letter.”

The taxpayer opt to bypass the pre-clearance request phase, and submit an Offshore Voluntary Disclosure Letter without obtaining pre-clearance

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**IRS MATTERS, CONT.***(Continued from page 8)*

from the IRS. A taxpayer opting out of pre-clearance would be required to mail the Offshore Voluntary Disclosure Letter to the IRS at the following address:

**Internal Revenue Service  
Criminal Investigation  
ATTN: Offshore Voluntary  
Disclosure Coordinator  
Philadelphia Lead Development  
Center  
600 Arch Street, Room 6406  
Philadelphia, PA 19106**

The Offshore Voluntary Disclosure Letter requires the taxpayer to list the aggregate value of all offshore accounts for the period from 2003 through 2010 and the total unreported income from offshore accounts for the same period. Once the letter has been reviewed by the IRS, the taxpayer will receive notice as to whether the disclosure has been preliminarily accepted or declined. If the disclosure is preliminarily accepted, the taxpayer must submit all required forms and payment by the August 31 deadline to the following address:

**Internal Revenue Service  
3651 S. I H 35 Stop 4301 AUSC  
Austin, TX 78741  
ATTN: 2011 Offshore Voluntary  
Disclosure Initiative**

As noted, a taxpayer may request a 90-day extension of the August 31st deadline to complete a submission under OVDI. To qualify for the extension, the taxpayer must demonstrate a good faith attempt to comply fully before August 31st. The good faith attempt to comply must include the properly completed and signed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.

**Opting Out of OVDI Program**

Taxpayers who have chosen to participate in the OVDI are also given

the option to "opt-out" of the program, an irrevocable decision which could lead to the taxpayer owing more than he or she would owe under the OVDI. By choosing to opt out, the taxpayer is electing to instead undergo a standard audit by the IRS. Such a decision is advantageous in a limited number of cases. A taxpayer might choose to opt out if, given the facts of the case, the penalties imposed under the OVDI appear too severe.

A taxpayer who violated the FBAR reporting requirements may fare better by opting out of the program if the violation was not willful or if the violation was based on the written advice of an independent legal advisor. The maximum penalty if the violation was not willful is \$10,000 for each non-willful violation and no penalty is imposed if the violation was based on the written advice of an independent legal advisor. In either case, the maximum penalties imposed would likely be less than the twenty-five percent (25%) mandatory penalty imposed under the OVDI.

Opting out of OVDI is not without risk, because an argument that the violation lacked intent is one which if lost, could result in the taxpayer facing criminal penalties. The IRS takes the position that the willfulness requirement is satisfied if the taxpayer makes a "conscious effort" to avoid awareness of FBAR reporting. Form 1040, Schedule B refers to instructions which mention FBARs. Although the IRS is of the view that a person with foreign accounts should read the instructions, the fact that a taxpayer checked the wrong box, or no box, on Schedule B could be insufficient by itself to establish that the FBAR violation was attributable to willfulness. However, this is not an area in which risks should be taken.

To opt out of OVDI, the taxpayer must provide a written statement of intent. The written statement is reviewed by a centralized review committee which decides whether to grant the withdrawal or assign the case for other treatment. In making its decision, the committee considers whether

the OVDI penalties will be too severe given the facts of the case.

*[Rebecca K. Richards contributed in the research and drafting of this article.]*

\* \* \*

The IRS has issued final regulations that provide a five-month extension to file partnership, estate and fiduciary tax returns. TD 9531. The final regulations for the most part adopt temporary regulations promulgated in 2008. The rationale for a shorter extension period for these entities as opposed to the six-month extension available for individuals is that many taxpayers require Schedule K-1 forms from these entities in preparing their returns.

\* \* \*

Following several years of increases, the IRS Spring 2011 Statistics of Income Bulletin notes a 3.5 percent drop in the number of returns filed by individual with \$200,000 or more of AGI for tax year 2008. In 2008, 4.3 million individual returns reported income of \$200,000 or more. The two largest deductions taken by those taxpayers were for taxes paid and mortgage interest. Returns of 3.9 million higher income taxpayers reported charitable deductions; and 1.5 million claimed the foreign tax credit.

Among individuals with \$200,000 or more of AGI in 2008, (i) 3.8 million taxpayers reported salary and wage income of \$1.2 trillion; (ii) 1.3 million taxpayers reported income from partnerships and S corporations of \$446 billion; (iii) 1.3 million taxpayers reported capital gains of \$417 billion; and (iv) 3.2 million taxpayers reported dividend income of \$125 billion.

The Report noted that donors filed 234,714 Form 709 gift tax returns for tax year 2008. Children accounted for 48.9 percent of all gifts, grandchil-

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## IRS MATTERS, CONT.

*(Continued from page 9)*

dren accounted for 24.7 percent, and gifts to other relatives accounted for 10.4 percent. Gifts to charities accounted for less than one percent of all gifts made in 2008.

\* \* \*

The IRS has announced final regulations that provide automatic five-month extensions to file most partnership, estate and trust returns. The purpose of the regulations is to better coordinate the filing requirements of those returns with individual taxpayers on extended six-month deadlines who require Schedule K-1s in order to file T.D. 9531.

IRC Code Section 6045(g), enacted in 2008, requires brokers to report the adjusted basis and character of gain from sales of a "covered" security, which includes stocks, debt and other financial instruments. The requirements apply to stock acquired in 2011, but do not apply to dividend reinvestment plans and regulated investment companies until 2012. Notice 2011-56 allows taxpayers to revoke the broker's default method for basis reporting retroactively.

\* \* \*

On June 29, 2011, The 2011 mid-year report of National Taxpayer Advocate Nina E. Olson released on June 29, 2011, praised a recently announced IRS policy change making lien withdrawals more available to taxpayers in certain cases. However, the report expressed concern about the IRS practice of automatically filing tax liens based on a dollar amount rather than considering the taxpayer's financial situation. The Advocate believes that before filing a tax lien, the IRS should

balance the need to protect the government's interests in the taxpayer's assets with a corresponding concern for the financial harm the lien will

create for that taxpayer.

The report states that if the IRS has determined a taxpayer is suffering an economic hardship or possesses no significant assets, the filing of a lien is unlikely to further tax collection but will further damage a taxpayer's credit rating.

\* \* \*

**THE DECEDENT'S LAST WILL, CONT.**

(Continued from page 1)

disposition of real property, while a “testament” to referred to a disposition of personal property. Today, that distinction has vanished.

The will operates on the estate of the decedent, determining the disposition of all probate assets. However, its sphere of influence does not end there: Under NY Estates, Powers and Trusts law (EPTL), the will can dictate how estate tax is imposed on persons receiving both probate and nonprobate assets.

Probate assets are those assets capable of being disposed of by will. Not all assets are *capable* of being disposed of by will. For example, a devise of the Adirondack Northway to one's heirs — although a nice gesture — would be ineffective. Similarly, one cannot dispose by will of assets held in joint tenancy, such as a jointly held bank account or real property held in joint tenancy, since those assets pass by operation of law, regardless of what a contrary (or even identical) will provision might direct.

So too, a life insurance policy which designates beneficiaries other than the estate on the face of the policy would trump a conflicting will designation. However, litigation could ensue, especially if the conflicting will provision appeared in a will executed after the beneficiary designation was made in the insurance policy.

The reason for the insurance policy prevailing over the will designation is not altogether different from the situation involving the Northway: The insurance company will have been under a contractual obligation to pay the beneficiaries. That obligation arguably cannot be affected by a conflicting will provision since this would cause the insurance company to breach its obligations to the named beneficiaries under the life insurance contract, just as the transfer by Albany to the decedent's beneficiaries of title to the Northway would breach the obligation of New York to retain title over the public thoroughfare.

Note that the decedent could

properly dispose of the insurance policy by will if the life insurance policy instead named the estate of the decedent as the sole beneficiary. In fact, in that case, *only* the will could dispose of the insurance contract. If there were no will, the contract proceeds would pass by intestacy to the decedent's heirs at law.

If the testator has a good idea to whom he wishes the proceeds of the policy to pass following his death, it is generally a poor idea to own the policy outright, regardless of whether the proceeds of the policy are paid to the estate of the decedent or to beneficiaries named in the policy. This is so because if the decedent owns the policy, the asset will be included in his gross estate, and therefore will be subject to federal and New York estate tax. This result also illustrates the concept that the gross estate for federal and NYS estate tax purposes includes both probate and nonprobate property.

By virtue of transferring the policy into an irrevocable life insurance trust, the testator could avoid this potential estate tax problem. If the testator is planning to purchase a new policy, the trustee of a new or existing trust should purchase the policy. If the testator wishes to transfer an existing policy to a trust, the Internal Revenue Code (which New York Tax Law follows) provides that he must live for three years following the transfer for the policy to be excluded from his gross estate.

If the decedent is not sure to whom he wishes to leave the insurance policy, creating an irrevocable life insurance trust to own the policy may not be a good idea, since the beneficiary designation will be irrevocable. However, if the testator knows to whom he wishes the policy benefits to pass, an irrevocable trust may reduce estate tax. The insurance policy will also have greater asset protection value if placed in trust. Finally, the proceeds of the life insurance policy held in trust could be used by beneficiaries to pay estate taxes. This can be helpful if the estate is illiquid.

**II. Formalities of Execution**

A will may be executed by any person over the age of majority and of sound mind. The *Statute of Frauds* (1677) first addressed the formalities of will execution. Until then, the writing of another person, even in simple notes, constituted a valid will if published (orally acknowledged) by the testator. The statute required all devises (bequests of real property) to be in writing, to be signed by the testator or by some person for him in his presence and by his direction, and to be subscribed to by at least three credible witnesses.

The rules governing the execution of wills in New York and most other states (except Louisiana, which has adopted the civil law) have remained fairly uniform over the centuries. The common law rules of England have since been codified in the States. In New York, these statutory rules are found in the EPTL (“Estates, Powers and Trust Law”).

For a will to be valid, the EPTL provides that the testator must (i) “publish” the will by declaring it to be so and at the same time be aware of the significance of the event; (ii) demonstrate that he is of sound mind, knows the nature of his estate and the natural objects of his bounty; (iii) dispose of his property to named beneficiaries freely and willingly; and (iv) sign and date the will at the end in the presence of two disinterested witnesses.

While the execution of a will need not be presided over by an attorney, the EPTL provides that where an attorney does preside over execution, there is a presumption that will formalities have been observed. The execution of a “self proving” affidavit by the attesting witnesses dispenses with the need of contacting those witnesses when the will is later sought to be admitted to probate.

A will should be witnessed by two disinterested persons. A will witnessed by two persons, one of whom is interested, will be admissible into

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## THE DECEDENT'S LAST WILL, CONT.

(Continued from page 11)

probate. However, the interested witness will receive the lesser of the amount provided in the will or the intestate amount. A corollary of this rule is that anyone who receives less under the will than under intestacy would suffer a detriment by being the only other witness. In general, it is not a good idea for an interested person to witness a will, although there are of course times when this admonition cannot be heeded.

The rule is less harsh if the execution of the will is witnessed by two disinterested witnesses in addition to the interested witness. In this case, the interested witness is permitted to take whatever is bequeathed to him under the will, even if this amount is more than he would have received by intestacy.

### III. Rights of Heirs

Following the testator's death, the original will may be "propounded" to the Surrogate's Court for probate. For a propounded will to be admitted, the Surrogate must determine whether the will was executed in accordance with the formalities prescribed in the EPTL. If the decedent dies intestate (without a will) the estate will still need to be administered in order to dispose of the estate to "distributees." The term distributee is a term of art which defines those persons who take under the laws of descent in New York. A beneficiary under the will may or may not be a distributee, and *vice versa*.

All distributees, whether or not provided for in the will, have the right to appear before the Surrogate and challenge the admission of the will into probate. Thus, even distant heirs may have a voice in whether the will should be admitted to probate. Distributees may waive their right to appear before the Surrogate by executing a waiver of citation. A distributee waiving citation is in effect consenting to probate of the will. Distributees, either when asked to sign the waiver, or

when being served with a Citation, will be provided with a true copy of the will.

If a distributee does not execute a waiver, he must be served with a citation to appear before the Surrogate where he may challenge the admission of the will into probate. Since a distributee having a close relation to the decedent would be the natural objects of the decedent's bounty, the disinheritance of a closely related distributee would have a higher probability of being challenged than would the disinheritance of a distant heir.

Persons taking under the will who are not distributees are also required to be made aware that admission of the will into probate is being sought. Those persons would receive a Notice of Probate, but would have no statutory right to receive a citation. A Notice of Probate is not required to be sent to a distributee.

Any person in physical possession of the will may propound it for probate. Not propounding the will with respect to which one is in physical possession works to defeat the decedent's testamentary intent. Accordingly, legal proceedings could be brought by distributees (those who would take under the laws of intestacy) or other interested persons to force one in possession of the will to produce a copy of the will and to propound the will for probate.

It appears that an attorney in possession of the original will is under an ethical, if not a legal, duty to propound the will into probate. The NYS Bar Ethics Committee observed that an attorney who retains an original will and learns of the client's death

has an ethical obligation to carry out his client's wishes, and quite possibly a legal obligation...to notify the executor or the beneficiaries under the will or any other person that may propound the will...that the lawyer has it in his possession. N.Y. State 521 (1980).

### IV. Importance of Domicile

A will of a decedent living in New York may only be probated in the county in which the decedent was "domiciled" at the date of death. The traditional test of domicile is well established. "Domicile is the place where one has a permanent establishment and true home." J. Story, Commentaries on the Conflict of Laws § 41 (8th ed. 1883). Therefore, the will of a decedent who was a patient at NYU Medical Center for a few weeks before death but was living in Queens before his last illness would be probated in Queens County Surrogate's Court.

The issue of domicile has other important ramifications. For example, while New York imposes an estate tax, Florida does not. In addition, "ancillary" probate may be required to dispose of real property held by a New York domiciliary in another state. For this reason, it is sometimes preferable to create a revocable inter vivos trust to hold real property that would otherwise require probate in another jurisdiction. Converting real property to personal property by deeding it into a limited liability company might also provide a solution, since personal property (in contrast to real property) may be disposed of by will in the jurisdiction in which the will is probated.

### V. Admission to Probate

If no objections are filed, and unless the instrument is legally defective, the original instrument will be "admitted" to probate. In practice, clerks in the probate department make important decisions affecting the admission of the will into probate. For this reason, among a legion of others, probating of wills of decedents by persons other than attorneys is ill-advised.

Following the admission of the will into probate, the Surrogate will issue "Letters Testamentary" to the named Executor to marshal and dispose of assets passing under the will. If the will contains a testamentary

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**THE DECEDENT'S LAST WILL, CONT.**

(Continued from page 12)

trust, "Letters of Trusteeship" will be issued to named Trustees under the will. Letters Testamentary and Letters of Trusteeship are letters bearing the seal of the Surrogate which grant the fiduciary the power to engage in transactions involving estate assets.

**VI. Executors and Trustees**

The Executor and Trustee are fiduciaries named in the will whose duty it is to faithfully administer the will or testamentary trust. The fiduciary is held to a high degree of trust and confidence. In fact, a fiduciary may be surcharged by the Surrogate if the fiduciary fails to properly fulfill his duties. In most cases, there will be only one Executor, but occasionally a co-Executor may be named. The will may also contain a designation of a successor Executor and the procedure by which a successor Executor may be chosen if none is named. A mechanism by which an acting Executor may be replaced if unable to continue serving, or may depart, if he so wishes, would also likely be addressed in the appropriate will clause.

Even in cases of intestacy, a bank, for example, will require proof of authority to engage in transactions involving the decedent's accounts. The Surrogate will issue "Letters of Administration" to the Administrator of the estate of a decedent who dies intestate. An Administrator is a fiduciary of the estate, as is the Executor or Trustee.

A trustee designation will be made for trusts created in the will. In some cases, the Executor may also be named a Trustee of a testamentary trust, but the roles these fiduciaries play are quite different, and there may be compelling reasons for not naming the Executor as Trustee. For example, the Executor may be older, and the beneficiaries may be quite young. Here, it may be desirable to name a younger Trustee. The decedent might even wish that the Trustee be the parent. Multiple trustees may also be

named. A corporate or professional Trustee may be named to assist in managing Trust assets. One should be aware that trusts and trustees often form symbiotic relationships, and the costs of naming a corporate or professional Trustee should be carefully evaluated. Like the executor, a trustee is also a fiduciary.

One important rule to remember when naming a trustee is that under the EPTL, a trustee may not participate in discretionary decisions regarding distributions to himself. Thus, if a sole trustee were also the beneficiary of a testamentary trust, another trustee would have to be appointed to decide the extent of discretionary distributions to be made to him.

The rule is actually a constructive one, in that it prevents deleterious estate tax consequences. The rule is also helpful from an asset protection standpoint, since a beneficiary who is also trustee could be required to make distributions to satisfy the claims of creditors. If the trust is a discretionary trust in which the beneficiary has no power to compel distributions, the trustee could withhold discretionary distributions under the creditor threat disappeared.

**VII. Avoidance of Intestacy**

Unless all or most assets of the decedent have been designed to pass by operation of law, intestacy is generally to be avoided, for several reasons: First, the decedent's wishes as to who will receive his estate is unlikely to coincide with the disposition provided for in the laws of descent. Second, the will often dispenses with the necessity of the Executor providing bond. The bond required by the Surrogate may constitute an economic hardship to the estate if the estate is illiquid. If there is no will, there will be no mechanism by which the decedent may dispense with the requirement of furnishing bond.

Third, a surviving spouse has a right to inherit one-third of the decedent's estate. If the will leaves her less, she may "elect" against it and take one-third of the "net estate."

However, if the decedent dies intestate, the surviving spouse has greater rights: Under the laws of descent in New York, a spouse has a right to one-half of the estate, plus \$50,000, assuming children survive. If there are no children, the surviving spouse is entitled to the entire estate.

In the event no administrator emerges from among the decedent's heirs at law, a public administrator will have to be appointed. Disputes among heirs at law may arise as to who should serve as Administrator. If there are six heirs at law with equal rights to serve as Administrator, it is possible that the Surrogate would be required to issue Letters of Administration to six different people.

What a will may provide is limited only by the imagination of the testator and the skill of the attorney. This is also why it is imperative to have a will in place even where the rules of descent (intestacy) are generally consistent with the decedent's testamentary scheme.

**VIII. Lost, Destroyed & Revoked Wills**

When executing a will, the testator is asked to initial each page. Paragraphs naturally ending on one page are sometimes intentionally carried over to another page to thwart tampering by improper insertion of a substitute page.

If the original will has been lost, a procedure exists for the admission of a photocopy, but the procedure is difficult and its outcome uncertain. Removing staples from the will to copy or scan it is a poor idea. To a degree not required of most other legal instruments, the *bona fides* of a will is dependent upon a finding that its physical integrity is unimpeachable, meaning that the will is intact and undamaged.

A will that has been damaged (e.g., staples removed for photocopying) may be admissible, though not without considerable difficulty. While the Nassau County Surrogate has ac-

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## THE DECEDENT'S LAST WILL, CONT.

(Continued from page 13)

cepted wills whose staples have been removed without undue difficulty, some New York Surrogates take a dim view of wills that are not intact.

If the original will cannot be located and was last in the possession of the decedent, there is a presumption that the will was revoked. The reasoning here is that in such cases it is likely that the decedent intentionally destroyed the will, thereby revoking it.

Revocation will also occur if the will has been mutilated. In some jurisdictions, if provisions of the will have been crossed out, the will be deemed to have been revoked. In other jurisdictions, crossing out provisions will not invalidate the will, but will result in the instrument being construed without the deleted provisions.

A will may be revised in two ways: First, a codicil may be executed. A codicil is a supplement to a will that adds to, restricts, enlarges or changes a previous will. The Execution of a codicil requires adherence to will formalities. The second and more effective means of revising a will is to execute a new one. The first paragraph of a will typically provides that all previous wills are revoked.

#### IX. Whether to Destroy or Retain The Old Will

Whether to retain an old will is the subject of some disagreement. This disagreement likely arose because there are situations where the will should be destroyed, and situations where it should not be destroyed.

Since a new will expressly revokes the previous will, the natural inclination might be to "tear up" an old will after executing a new one. However, this is not always the preferred course of action. The new will may be lost, secreted, successfully challenged, or for whatever reason not admitted to probate. In this circumstance, the existence of the old will may be of great moment.

If the new will is not admitted to probate, an old will may be pro-

pounded for probate. If there had been a previous will, but it was destroyed, the decedent will have died intestate. In that case, the laws of descent will govern the disposition of the decedent's estate. The retention of the old will is insurance against the decedent dying intestate. In intestacy, the laws of descent govern the disposition of the estate.

There are situations where the decedent would prefer the laws of descent to govern. In that case, it would make perfect sense for the decedent to destroy the old will. However, in many if not most situations, the decedent would prefer the terms of the old will to the laws of descent. In these cases, the old will should not be destroyed.

To illustrate a situation where the old will should not be destroyed: If a will contestant demonstrates that the decedent was unduly influenced when executing the new will, an older will with similar terms could be propounded for probate. If the decedent had disinherited or restricted the inheritance of the will contestant in the previous will as well, the existence of the old will is invaluable, since a disgruntled heir, friend, or lover would be less likely to mount a will contest. Even if a will contest were to occur, and the will contestant were successful, the victory would be pyrrhic, since the contestant would fare no better under the previous will. Knowledge of the existence and terms of the previous will would also reduce the settlement value.

In some situations the old will should be destroyed: If the new will *dramatically changes* the earlier will, the testator might prefer the rules of intestacy to the provisions in the old will. Here, destroying the old would obviously preclude its admission to probate; the laws of intestacy would govern.

To illustrate, assume wife's previous will left her entire estate to her second husband from whom she recently separated. Under pressure from her children from a previous marriage, wife changes her will and leaves her

entire estate to those children. If wife dies, a will contest would be possible. Admission of the old will (leaving everything to her husband) into probate would be the last thing that wife would want. Since intestacy (where her husband takes half the estate) would be preferable to the old will, it would be prudent for wife to destroy the old will (and any copies).

Equitable doctrines may come into play where the revocation of a previous will would work injustice. Under the doctrine of "dependent relative revocation," the Surrogate may revive an earlier will, even if that will was destroyed, if the revised will is found to be inadmissible based upon a mistake of law. When invoked, the doctrine operates to contravene the statutory rules with respect to the execution and revocation of wills. If the doctrine is applicable, there is a rebuttable presumption that the testator would have preferred the former will to no will at all.

#### X. Objections to Probate

Objections to probate, if filed, may delay or prevent the will from being admitted to probate. If successful, a will contest could radically change the testamentary scheme of the decedent. To deter will contests, most wills contain an *in terrorem* clause, which operates to render void the bequest to anyone who contests the bequest. The effect of the *in terrorem* clause is that the failed bequest is disposed of as if the person making the challenge had predeceased the decedent.

Were *in terrorem* clauses effective, will contests would not exist. Yet they do. Therefore, the bark of such clauses appears to be worse than their bite. Still, there is no more reason not to include an *in terrorem* clause in a will than there would be for omitting other boilerplate language. The existence of the clause is not likely to upset most beneficiaries' expectations, and it could cause a disgruntled heir to pause before commencing a will contest.

Although some believe that  
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leaving a small amount to persons whom the testator wishes to disinherit accomplishes some valid purpose, doing this actually accomplishes very little. A small bequest to a distributee will neither confer upon nor detract from rights available to the distributee, and consequently would have little bearing on the ultimate success of a will contest. Some testators prefer to use language such as "I intentionally leave no bequest to John Doe, not out of lack or love or affection, but because John Doe is otherwise provided for" or perhaps language stating that the lack of a bequest is "for reasons that are well understood by John Doe."

**XI. Liability and Apportionment of Estate Tax**

Who will bear the responsibility, if any, for estate tax is an important — but frequently overlooked — issue when drafting a will. The default rule in the EPTL is that all beneficiaries of the estate pay a proportionate share of estate tax. One exception to the default allocation scheme is that estate tax would rarely be apportioned to property passing to the surviving spouse and which qualifies for the full marital deduction.

The technical reason for not apportioning estate tax to a bequest that qualifies for the marital deduction is that it leads to a reduced marital deduction, and a circular calculation, with an attendant increase in estate tax. To qualify for the marital deduction, a bequest to the surviving spouse must pass outright or in a qualified trust. If estate tax is paid from the bequest, then the amount passing outright (or in trust) is diminished. This results in a circular calculation.

The same rationale applies to other bequests that qualify for an estate tax deduction, such as a charitable bequest to an IRC Section 501(c)(3) organization. If a large residuary bequest were made to a charity, the testator might want the charity to bear the entire liability for estate tax, even

though such a direction in the will would result in a net increase in estate tax liability.

Note that property not included in the decedent's gross estate is never charged with estate tax, even if the disposition occurs by reason of the decedent's death (e.g., proceeds of an irrevocable life insurance trust paid to a beneficiary of the trust). This is because under IRC Section 2033, estate tax is imposed on "the value of all property to the extent of the interest therein of the decedent at the time of his death." Assets not owned by the decedent at the time of his death are not "interests" within Section 2033, and therefore are not part of his gross estate for purposes of the Internal Revenue Code.

The allocation of estate tax liability is therefore within the exclusive jurisdiction of the decedent's will. The default rule found in the EPTL can be easily overridden by a provision in the tax clause of the will. This gives the drafter flexibility in apportioning estate tax. In a sense, the ability of the will to control the tax consequences of assets passing outside of the probate estate is an exception to the rule that the will governs the disposition only of probate assets. If the decedent dies intestate, the default EPTL provision will control.

In many cases, the testator will choose the default rule under the EPTL, which is to apportion estate tax among the beneficiaries according to the amounts they receive. As noted, no estate tax is apportioned to assets not part of the gross estate even if those assets pass by reason of the testator's death. For example, the proceeds of an irrevocable life insurance trust are not included in the decedent's gross estate, and any attempt to impose estate tax liability on the named beneficiary of the policy would fail. However, if the insurance policy were owned by the decedent at his death and passed to either a named beneficiary or was made payable to his estate, the beneficiary (or the estate) could and would be called upon to pay its proportionate share of estate tax, unless expressly

absolved of that responsibility in the will.

Since the testator is free to change the default rule, the tax clause could direct that estate tax be paid entirely from the residuary estate, "as a cost of administering the estate." Alternatively, the tax clause could direct that estate tax be paid out of the probate estate, meaning that the estate tax would be apportioned to all persons taking under the will. Alternatively, the will might also be silent with respect to the estate tax, in which case the EPTL default rule would govern.

To illustrate the importance of the tax clause provision, assume the decedent's will contained both specific bequests and residuary bequests. Assume further that the decedent owned a \$1 million life insurance policy naming his daughter as beneficiary.

If the will is silent concerning estate tax, the default rule of the EPTL would control, and every beneficiary, whether taking under the will by specific or residuary bequests, or outside of the will (*i.e.*, insurance policy payable by its terms to a named beneficiary), would pay a proportionate share of estate tax.

If the tax clause instead provided that all taxes were to be paid from the residuary estate as a cost of administration, no tax would be imposed on the daughter who receives the insurance, or on persons receiving preresiduary specific bequests under the will.

**XII. Revocable *Inter Vivos* Trusts as Testamentary Substitutes**

Relatively speaking, probate in New York is neither expensive nor time-consuming. Nevertheless, a revocable *inter vivos* trust is sometimes utilized in place of a will. Avoiding probate may be desirable if most assets are held jointly or would pass by operation of law. In that case, the necessity of a will would be diminished. Other reasons for avoiding probate may stem from considerations of cost or concerns about privacy. While trusts are generally private, wills are

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generally public.

Letters of trusteeship are not required for an *inter vivos* trust, since the trust will have become effective prior to the decedent's death, and the trustee will already have been acting. Revocable *inter vivos* trusts have been said to reduce or estate taxes. While technically true, the assertion is somewhat misleading. While a properly drafted revocable *inter vivos* trust may well operate to reduce estate taxes, a properly drafted will can also accomplish that objective. Revocable *inter vivos* trusts do accomplish one task very well: They eliminate the need for ancillary probate involving real property situated in another state.

A revocable *inter vivos* trust is funded during the life of the grantor (or trustor) with intangible personal property such as brokerage accounts, tangible personal property such as artwork, real property, or anything else that would have passed under a will. Assets titled in the name of a revocable *inter vivos* trust may reduce costs somewhat in certain situations.

Unlike a will, a revocable *inter vivos* trust operates with legal force during the grantor's life. When evaluating the potential probate costs that could be avoided using a trust, one should also consider the cost of transferring title of assets to a revocable *inter vivos* trust. If probate is not expected for many years, the present value of that cost may not exceed the immediate cost of transferring the testator's entire estate into trust.

Most estate planning tax objectives for persons who are unmarried can be accomplished in a fairly straightforward manner using a revocable *inter vivos* trust. However, unless the bulk of assets are held in joint tenancy, or titled in some other form that avoids probate, avoidance of probate would not likely justify foregoing a will in favor of an *inter vivos* trust as the primary testamentary device.

Between spouses, "joint" revocable *inter vivos* trusts have been used to avoid probate. In some community

property jurisdictions, of which New York is not one, certain federal income tax advantages among spouses may be achieved by using a joint revocable *inter vivos* trust. This advantage arises because the IRS may permit a step-up in basis at date of death for all assets held by a joint *inter vivos* revocable trust in community property states.

However, joint revocable *inter vivos* trusts between spouses have engendered a flurry of private letter revenue rulings from the IRS addressing basis issues. Some of the rulings are adverse. Consequently, use of joint revocable trusts in non-community property states should be avoided.

### XIII. Grantor & Nongrantor Trusts

Income tax consequences of a revocable *inter vivos* trust actually depend on whether the trust is a "grantor" trust or a "nongrantor" trust for purposes of the Internal Revenue Code. If the revocable *inter vivos* trust is drafted as a grantor trust — and most revocable *inter vivos* trusts are — no income tax consequences will result. Two common ways of accomplishing grantor trust status are for the grantor to retain the power to substitute trust assets of equal value, or to retain the right to borrow from the trust in a nonfiduciary capacity without the consent of an adverse party. If either of these powers and rights are contained in the trust, grantor trust status should ensue.

A grantor trust is "transparent" for federal income tax purposes, and the grantor will continue to report income on his income tax return as if the trust did not exist. This is a slight overstatement, as some tax advisors do recommend that the trust obtain a taxpayer identification number even for a grantor trust, and recommend filing an income tax return for the trust, but noting on the first page of the return that "the trust is a grantor trust, and all income is being reported by the grantor."

On the other hand, if the revocable *inter vivos* trust is drafted as a "nongrantor" trust, then the trust be-

comes a new taxpaying entity, and must report income on its own fiduciary income tax return. A reason for choosing nongrantor trust status might be a desire to shift income to lower income tax bracket beneficiaries.

A *nongrantor* trust, for income tax purposes, is a trust in which the grantor has given up sufficient control of the assets funding the trust such that a complete transfer for income tax purposes has occurred. A *grantor* trust, for income tax purposes, is a trust in which the grantor has not given up sufficient control over the assets funding the trust such that a complete transfer for income tax purposes has not occurred.

Both revocable *inter vivos* trusts "defective" grantor trusts used in estate planning are typically grantor trusts. In both cases the grantor has retained sufficient rights and powers such that the transfer is incomplete for federal income tax purposes. The difference between the two lies in differing transfer tax consequences when the trust is formed. Where a "defective" grantor trust is employed, the grantor also relinquishes the right to revoke the trust. This makes the trust irrevocable and the transfer complete for transfer (*i.e.*, gift and estate) tax purposes. However, the transfer is still incomplete for income tax purposes.

Defective grantor trusts are useful when the grantor wishes to make use of the gift tax exemption to shift appreciation out of his estate, but at the same time wishes to remain liable for the annual income tax generated by trust assets. By remaining liable for income tax, the trust assets will grow more quickly, with no annual income tax burden being imposed on the trust.

### XIV. Transferring Assets Into Revocable *Inter Vivos* Trust

Transferring intangible assets into an *inter vivos* trust is fairly straightforward: A brokerage or bank account need only be retitled into the name of the trust. So too, ownership of

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real property would simply require transferring the property by quitclaim deed into the trust.

Transferring tangible personal property is more problematic. Care must be taken to execute formal legal documents evidencing the transfer. Only then will the Trustee be comfortable making the distributions called for in the trust to beneficiaries. For example, if valuable artwork is transferred into a revocable *inter vivos* trust with a flimsy one page undated document, it may be difficult to justify the transfer to the decedent's heirs at law who may in effect be disinherited by virtue of the trust. In contradistinction, it would be difficult for a disgruntled heir to challenge a specific bequest of artwork in a will.

### XV. Irrevocability of *Inter Vivos* Trust At Death of Grantor

A revocable *inter vivos* trust may be made irrevocable prior to the death of the grantor. If the trust is a grantor trust, the trust will resemble a "defective" grantor trust discussed above. If the trust is a nongrantor trust, then the transfer will be complete for income, gift and estate tax purposes.

A revocable *inter vivos* trust becomes irrevocable at the death of the grantor, since the grantor, having died, can no longer revoke it. Since Letters of Trusteeship are not required, the Surrogate will not even be aware of the trust. In contrast, the Trustee of a testamentary trust will be required to request Letters of Trusteeship from the Surrogate.

In general, unless a transfer is complete for transfer tax purposes, creditor protection will not arise. Therefore, revocable *inter vivos* trusts have virtually no asset protection value. Since the transfer may be revoked, no transfer for federal transfer tax purposes will have occurred when assets are retitled into the name of a revocable *inter vivos* trust. A creditor will be able to force the grantor of a revocable *inter vivos* trust to revoke the trust,

thereby rescinding the transfer and laying bare the assets for the disposal of the creditor. It is conceivable that a revocable *inter vivos* trust drafted as a nongrantor trust would have slight creditor protection, but this would probably be a theoretical point with little practical significance.

### XVI. The "Pour Over" Will

What would bring to the attention of Surrogate's Court the existence of the trust would be the decedent's "pour over" will, if it were probated. The purpose of a pour over will is to collect and dispose of assets not passing by operation of law at the decedent's death, and which were not transferred into the trust earlier. If no probate assets exist at the decedent's death, there would be no reason to probate the pour over will. Where probate of the pour over will is required, the expense of probate, although not entirely avoided, would be reduced.

### XVII. Testamentary Trusts

The coverage of wills in the EPTL is extensive, while that of revocable *inter vivos* trusts is relatively sparse. Although trust law is well developed, it is less developed for revocable *inter vivos* trusts. Probate lends an aura of authoritativeness and finality to the administration of an estate that is simply not possible where a revocable *inter vivos* trust is used. In many cases, tax planning is actually more straightforward where a will is utilized rather than an *inter vivos* trust. For these reasons, most attorneys reserve the use of revocable *inter vivos* trusts to unique situations where they are peculiarly advantageous as testamentary vehicles.

Both credit shelter and marital trusts may be funded at the death of the grantor of a revocable *inter vivos* trust which becomes irrevocable at death. As noted, revocable *inter vivos* trusts to a limited extent operate as will substitutes. However, another type of trust may present itself in the will. Many wills contain *testamentary*

*trusts*. Testamentary trusts are often the foundation of the decedent's will. Skillful drafting further important estate tax objectives. Testamentary trusts also serve to insulate the assets from potential creditors of the beneficiaries, or may protect the beneficiaries from their own immaturity or profligacy.

Testamentary trusts funded by the will may take the form of a marital trust for the benefit of a spouse, or a credit shelter trust for the benefit of children, grandchildren. The surviving spouse may also be a beneficiary (but not the sole beneficiary) of the credit shelter trust. Testamentary trusts often combine the benefit of holding property in trust with attractive tax features.

Note that a revocable *inter vivos* trust becomes revocable at the death of the grantor. However, the trust is not a testamentary trust because it does not arise at the death of the decedent. It has already been in existence. Nevertheless, testamentary trusts and revocable trusts that become irrevocable at the date of the decedent's death may operate in tandem, and may, if the terms of the trusts permit, become unified after the decedent's death.

### XVIII. Estate Taxes

Neither property funding a marital trust nor property funding a credit shelter trust will result in estate tax in the first spouse to die. The mechanism for arriving at the incidence of no tax differs: In the case of a marital bequest, the amount is includable in the decedent's gross estate, but a complete marital deduction will cancel the estate tax. In the case of a bequest utilizing the applicable exclusion amount, no estate tax will arise because Congress or Albany issues a credit nullifying the estate tax liability. As in most areas of the tax law, a credit is preferable to a deduction. In the case of the marital deduction, the property will eventually be included in the estate of the surviving spouse, unless it is consumed by the surviving spouse during that spouses lifetime, or gifted. If con-

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sumed, no tax will arise. If gifted, the gift will be subject to federal gift tax.

The largesse of Washington is greater than that of Albany with respect to the applicable exclusion amount: While Washington currently allows \$5 million to pass tax-free to beneficiaries other than the spouse, Albany allows only \$1 million to pass tax-free at death. Note that there would be no reason to waste the credit for bequests in which only the spouse benefits, since marital bequests can be drafted to qualify for the marital deduction. Both Washington and Albany allow a full marital deduction for lifetime and testamentary gifts to a spouse.

There is one catch to the generosity of Washington: The Internal Revenue Code includes in the \$5 million applicable exclusion amount lifetime gifts. So a lifetime gift of \$1 million would reduce to \$4 million the amount that can pass at death without the imposition of estate tax. Furthermore, the gift tax exemption amount may be reduced after 2012. In a rush to complete the tax bill in late 2010, Congress unexpectedly increased the lifetime gift tax exemption from \$1 million to \$5 million. If President Obama is reelected, there is no assurance that his administration will not seek to reduce the lifetime gift tax exclusion amount.

There is another fundamental difference between the philosophy of New York and Washington concerning transfer taxes: While the IRS taxes lifetime gifts, New York does not. Therefore, making lifetime gifts before 2012 to avoid the inclusion of assets in the estate for New York estate tax purposes makes sense for testators with large estates. Making such gifts now will be neutral for federal purposes (since the applicable exclusion amount applies equally to lifetime and testamentary transfers) but will reduce New York State estate tax by 16 percent of the amount of the gift. (Sixteen percent is the maximum rate of estate tax now imposed by New York.)

**XIX. QTIP Trusts & Credit Shelter Trusts**

In general, to qualify for a complete marital deduction, property must pass outright or in a qualifying trust to the surviving spouse. A "QTIP" marital trust is such a qualifying trust. The QTIP grants the surviving spouse a lifetime income interest, and perhaps a discretionary right to trust principal. The decedent retains the right to designate ultimate trust beneficiaries, but no beneficiary other than the surviving spouse can have any interest in QTIP trust assets during the life of the surviving spouse. QTIP trusts are sometimes used in second-marriage situations, or in situations where the testator is concerned that the surviving spouse might deplete trust assets leaving few assets for his children. The surviving spouse with an interest in a QTIP trust has the right to demand that the trustee make nonproductive assets productive.

For estate tax purposes, the IRS requires that the estate of the surviving spouse include the fair market value of the assets in the QTIP trust at her death. For income tax purposes, two basis step ups occur: The first at the death of the decedent, and the next basis step up at the death of the surviving spouse.

Even though the property in a QTIP trust does not "pass" to the surviving spouse outright, Congress justified marital deduction on the basis of the surviving spouse having a lifetime income interest in the trust, and no other beneficiary having an interest during the life of the surviving spouse. The deduction provided by the Internal Revenue Code for assets funding a QTIP trust is actually an exception to the "terminable interest" rule. That rule provides that no marital deduction can be allowed for a bequest to a surviving spouse of an interest that "terminates."

The surviving spouse can be given the right to receive discretionary distributions of principal from a QTIP trust for her "health, comfort and

maintenance" without triggering adverse estate tax consequences. The surviving spouse may also be given a "five and five" power, which gives the surviving spouse the noncumulative right to demand on an annual basis from the trust an amount which is the greater of (i) five percent of the value of the trust or (ii) five thousand dollars.

Giving the spouse more rights than these in a QTIP trust could result in the IRS arguing that the trust no longer qualifies as a QTIP trust. Since the decedent would have retained the right to name ultimate trust beneficiaries, the trust would also not qualify for the unlimited marital deduction as a general power of appointment trust. (If the trust were a general power of appointment trust, the surviving spouse would have the right to appoint trust assets, which she does not in a QTIP trust). Thus, the marital deduction could be imperiled.

A credit shelter trust takes the asset out of both the estates of the testator and the spouse permanently. A surviving spouse may or may not be given an interest in a credit shelter trust. Again, the surviving spouse should not be given too great an interest in the credit shelter trust; otherwise, the IRS could argue that the assets are includible in her estate. Still, it appears entirely reasonable to give the spouse a right to income and a discretionary right to principal for her health, comfort and maintenance. Health, comfort and maintenance are ascertainable quantities generally considered to be within the discretion of the trustee. Accordingly, most courts would not challenge the trustee's discretion. However, the IRS would be less reluctant to question the scope of the trustee's discretion if the IRS believed that the trustee had exceeded the scope of his discretion.

The credit shelter trust would provide for other beneficiaries. If the intended beneficiaries of a credit shelter trust were older, then the testator would likely have creditor protection objectives in mind when deciding to

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leave assets to his mature children in trust rather than outright.

Funding the credit shelter trust within the will involves determining how many assets the surviving spouse may need. Until a few years ago, when the applicable exclusion amount was less than \$5 million, it was sometimes desirable to fund the credit shelter trust with the maximum amount, thereby removing the assets from the estate of both spouses.

With the federal applicable exclusion amount at \$5 million, maximizing the amount funding the credit shelter trust may operate to reduce or eliminate an alternate bequest to the surviving spouse. On the other hand, if the credit shelter trust is underfunded and the marital trust overfunded, the estate of the surviving spouse might needlessly become subject to New York estate tax.

In the majority of cases tax considerations are secondary — as they should be — to the desire of the decedent to provide for his or her spouse. Use of a disclaimer provides post-mortem flexibility, in that it allows the surviving spouse to renunciate assets not required, with extremely favorable transfer tax consequences.

## XX. Disclaimers

In general, if a person executes a written disclaimer within nine months of the decedent's death, and has not accepted any of the benefits of the disclaimed assets, then the property will pass as if the disclaimant had predeceased. A significant transfer tax benefit may result from a properly executed disclaimer. If a person accepts a bequest, and then decides to transfer the bequest, a taxable gift will have been made. In contrast, if the person disclaims the bequest, no taxable gift has occurred, since the person never received the property.

Although a disclaimant may not direct property to a specific person, the will may be drafted to contain specific language providing that a disclaimer

made by a surviving spouse could fund a credit shelter or other trust in which she is a beneficiary. The language might provide that the surviving spouse's disclaimer would add to or fund a credit shelter trust in which she is a lifetime beneficiary. If the surviving spouse is given an income interest in a trust into which she disclaims, this may increase the likelihood that she will disclaim. This may reduce or eliminate estate tax at her death, yet still provide her with lifetime enjoyment of trust assets. If the surviving spouse cannot be relied upon to disclaim what she will not need, the trustee's discretion with respect to distributions of principal from a credit shelter (or other) trust may serve to adequately protect the interest of other beneficiaries, such as the children.

The reasons for a disclaimer are legion, and they are by no means limited to situations involving taxes. A disclaimer may also be made to protect assets from claims of creditors. In some jurisdictions, such as New Jersey, a disclaimer that works to defeat the rights of creditors is fraudulent. However, in New York a disclaimer made to defeat the rights of a creditor is valid. However, a disclaimer cannot work to defeat the rights of the IRS if the named beneficiary under the will exercises the disclaimer to defeat the those rights. *Drye v. U.S.*, 428 U.S. 49 (1999).

## XXI. The Right of Election & Testamentary Substitutes

A will may be used to disinherit children, but not a spouse. Divorce will not invalidate a will, but will have the effect of treating the former spouse as if she had predeceased. On the other hand, a disposition made to a former spouse following a divorce — or even a bequest made prior to a divorce but expressly stating that the bequest survives divorce — would be valid.

In New York, the surviving spouse must be left with at least one-third of the testator's estate. Otherwise, the surviving spouse may "elect" against the will, and take one-third of

the "net estate." If the elective share of the surviving spouse exceeds what the surviving spouse received under the will or by operation of law, the estate of the decedent will be required to pay the electing spouse that difference. If the property was already transferred to another person, the statute would appear to require that the transfer be rescinded.

If a spouse wished to circumvent the rule that he or she bequeath at least one-third of his or her estate to the surviving spouse, this could theoretically be accomplished by making gifts before death of large portions of the estate. To foreclose this opportunity to avoid the elective share rule, the legislature created the concept of "testamentary substitutes."

The net estate, which is the basis upon which the elective share operates, includes "testamentary substitutes" in addition to other assets comprising the decedent's estate. If the decedent dies intestate, testamentary substitutes are generally those assets which the decedent transferred before death, which are no longer part of his probate or nonprobate estate.

The intent of the legislature in creating the concept of testamentary substitutes was to protect the surviving spouse from the intentional depletion of the decedent's estate by means of lifetime transfers occurring before the spouse's death. Although the definition of testamentary substitutes operates primarily on transfers made in the year before the decedent's death, some transfers qualifying as testamentary substitutes may have been made years earlier.

Life insurance is not a testamentary substitute. Thus, the purchase of a life insurance policy within a year of death will not be part of the net estate for calculating the elective share, even if the beneficiary is other than the surviving spouse. It is believed that the reason life insurance is not within the statutory class of testamentary substitutes is not based upon any legally distinguishable characteristic of life insurance, but rather on the reality that

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were it so classified, the life insurance industry would be adversely affected.

The concept of testamentary substitutes, although primarily operating to prevent depletion of the net estate for elective share purposes, is not limited to protecting rights of the surviving spouse. The statute provides that testamentary substitutes include transfers "whether benefiting the surviving spouse or any other person."

Thus, if an elective claim were made by a surviving spouse, a child could argue that a transfer made years earlier by the decedent to the surviving spouse was actually a testamentary substitute. The child's argument, if successful, would augment the net estate with respect to which the surviving spouse would be entitled to one-third.

However, since the surviving spouse would already hold title to the property constituting a testamentary substitute, this would "count" toward her elective share. Thus, for elective share purposes, the surviving spouse would be entitled only to one third of an asset already owned by her. This could result in the elective share being less than what the spouse otherwise received under the will or by operation of law. In that case, the spouse would simply forego the elective share.

In general, the categorization of a transfer as a testamentary substitute works to the disadvantage of the electing spouse if she already owns a significant number of assets that may be susceptible to being classified as a testamentary substitute. This is because the entire value of the asset will "count" toward meeting her one-third elective share.

To illustrate, if a spouse transfers title to the marital residence but retains the right to enjoy or possess the property during his life, the transfer may be deemed to constitute a testamentary substitute. The inclusion of the residence would increase the size of the net estate with respect to which the surviving spouse would be entitled to a third. Being in title to the resi-

dence, its entire value would count toward satisfying the requirement that the surviving spouse receive one-third of the net estate.

A spouse may waive the statutory right under EPTL 5-1.1A to elect against the will of the other spouse or, may under EPTL 4-1.1, may waive the right to one-half of the spouse's estate in the event of intestacy.

## XXII. Residuary & Preresiduary Bequests

There are two classes of bequests: *preresiduary* bequests and *residuary* bequests. Preresiduary bequests, which generally consist of specific bequests, are sometimes easier to administer than residuary bequests. Specific bequests of tangible personal property are almost always preresiduary bequests. Specific bequests might also be made of intangible personal property, such as money or bank accounts. However, to the extent money, bank or brokerage accounts are not disposed of by specific bequest, they will be disposed of in the residuary estate.

A "bequest" then is gift of under the decedent's will. A "legacy" is a bequest of personal property, while a "devise" is a bequest of real property. An "inheritance" as it is typically thought of is somewhat of a misnomer, since it refers to real or personal property received by heirs pursuant to the laws of descent (intestacy). However, a nontechnical meaning of "inheritance" refers to bequests under the will. The failure to use the correct term (e.g., referring to a bequest of land as a legacy) in a will would of course not defeat the bequest.

When administering the estate, the Executor will first determine specific bequests to be made from probate assets. Every probate asset in the decedent's estate not disposed of by specific bequest will fall into the residuary estate, and be disposed of pursuant to the terms therein. A residuary bequest might resemble the following:

I give, bequeath and de-

vise all the rest, residue and remainder of my estate, both real and personal, of every nature and wherever situated . . . which shall remain after the payment therefrom of my debts, funeral expenses, expenses of administering my estate and the legacies and devises as hereinafter provided, to the following persons in the following proportions:

The will should also contain a provision dealing with simultaneous deaths. The will would typically provide that if any disposition under the depends on one person surviving another, if there is insufficient evidence concerning who died first, the other person will be deemed to have predeceased. An example would be where the decedent and his spouse die simultaneously, such as in an airplane or car accident. Here, the effect of the provision would be to assume for purposes of the decedent's will the spouse predeceased.

The will may also impose a general requirement of survivorship. Thus, the instrument may require as a condition to taking under the Will that the person survive for a period of period of time (e.g., 90 days) following the death of the decedent. The reason for inserting the requirement if the beneficiary died soon after the decedent the decedent would rather that the bequest be made to other beneficiaries under his will rather to the beneficiary under his will who died before the estate was administered.

The residuary estate is often, though not always, disposed of by making gifts of fractional, rather than pecuniary amounts, to various persons either outright or in trust. If the bequest is made in trust, the "rule against perpetuities" prevents the creation of perpetual or "cascading" trusts. Black's Law Dictionary defines the rule against perpetuities as

[t]he common-law rule prohibiting a

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grant of an estate unless the interest must vest, if at all, no later than 21 years (plus a period of gestation to cover a posthumous birth) after the death of some person alive when the interest was created.

[The rule has its origin in the Duke of Norfolk's case decided by the House of Lords in 1682. The Lords believed that tying up property for many generations was wrong. A few states, among them New Jersey, have abolished the common law rule by statute. Other states, among them New York, have codified the common law rule. Still others have taken different approaches. Delaware has eliminated the rule by statute for real property, and has extended the vesting period for personal property from 21 years to 110 years. Forward-looking Utah has not abolished the common law rule, but has extended the vesting period to 1000 years. Finally, some states have adopted the "Uniform Statutory Rule Against Perpetuities," which limits the vesting period to 90 years.]

**XXIII. Formula Bequests**

A formula bequest is a bequest utilizing a formula specified in the will to determine the amount of the bequest. The formula might provide that the credit shelter trust be funded with the maximum amount that can pass free of federal estate tax, or the maximum amount that can pass free of federal or state estate tax. Formula bequests to a credit shelter or marital trust could be structure as either preresiduary or a residuary bequests.

Today, funding a credit shelter trust with the maximum amount that can pass free of federal estate tax would result in \$5 million being allocated to the trust; funding the trust with the maximum amount that would result in no federal or New York estate tax would result in funding the trust with only \$1 million. This is because the maximum amount that can pass free of New York State estate tax is

only \$1 million.

Depending on the size of the decedent's estate, foregoing \$4 million in a federal credit to save \$640,000 (.16 x \$4,000,000) may or may not make sense. If the decedent and his spouse are elderly and their estate is very large, wasting \$4 million of the federal credit at the death of the first spouse may actually result in more federal estate tax in the future. In general, if the couple wishes to reduce estate tax to zero at the first to die, the credit shelter trust will not be funded with more than \$1 million. However, one loophole the width of the lower Hudson does exist: Gifting the \$4 million during life and leaving the other \$1 million at death will result in no federal tax, because the applicable exclusion amount equals the total of both lifetime and testamentary transfers. The \$4 million gift will not be subject to New York gift tax, since New York has no gift tax. At the death of the first spouse to die, the credit shelter trust can be funded with \$1 million. Essentially, the \$640,000 in New York estate tax will have been avoided at no cost.

However, the testator must actually make a gift of this money during his lifetime. The reality is also that most people with estates of \$5 million are generally not willing to make gifts of \$5 million.

As is readily seen, small variations in language can have important funding consequences. It is for this reason that older wills should be periodically reviewed to ensure that they fund the appropriate trust with the proper amount. If the language of the will were clear, neither the Executor nor the Surrogate would have the power to redraft the will.

For example, if the will of a decedent who died in 2009 provided in a preresiduary bequest that the credit shelter trust was to be funded with the maximum amount that can pass free of federal estate tax, the Executor would clearly be required to fund the trust with \$3.5 million, if the estate had sufficient assets.

However, if the decedent with

the same will died in 2010, this language would be problematic, since the estates of persons dying in 2010 could elect out of the estate tax. If an election out of the estate tax were made, would the Executor be required to fund the trust denominated in the will as a credit shelter trust, since nothing would be needed to reduce federal estate tax to zero? Even if it were assumed that the Executor were required to fund the trust, what amount would he be required to transfer to the trustee? Would the amount be the amount which the Executor would have been required to fund the trust with had the estate not elected out of the estate tax?

Another equally troubling question exists: If the election out of the estate tax results in no estate tax, but increases the future income tax liability of certain beneficiaries, how is the estate required to allocate future built-in income tax gain? These questions might require the Executor to make difficult decisions and surmise what the intent of the decedent was. While it would be appropriate for a fiduciary to make these determinations, it would be preferable if the will were clear.

The problem of basis arises because as a condition to electing out of the estate tax, the Executor must "carry over" the basis of estate assets, rather than receive a step-up. This problem is mitigated somewhat by a provision allowing the Executor to step up the basis of \$1.3 million for assets passing to anyone. The Executor may also step up the basis of assets worth \$3 million passing to the surviving spouse.

**XXIV. Pecuniary and Specific Bequests**

A pecuniary or specific bequest is said to "lapse" if the named beneficiary predeceases. A specific bequest is said to "adeem" if the subject matter of the bequest no longer exists at the decedent's death. Another instance in which a bequest might fail is where there has been an "advancement." An advancement occurs where the dece-

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## THE DECEDENT'S LAST WILL, CONT.

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decendent makes a testamentary bequest, but "advances" the bequest to the beneficiary before death. For a gift to constitute an advance, it must be clearly demonstrated that the decedent intended it to be so, and the presumption is against advancements.

Specific bequests of personal property or cash must be worded carefully. Assume that the testator wishes to leave \$50,000 to his aunt Matilda. The bequest might be drafted in the following way:

I leave to my aunt Matilda the sum of \$50,000.

If Matilda is alive at the decedent's death, she will receive \$50,000. If Matilda has predeceased, most agree that the bequest should be paid to the estate of Matilda.

Suppose instead that the bequest was phrased in the following way:

I leave to my aunt Matilda the sum of \$50,000, if she survives me.

Here Matilda would receive \$50,000 if, and only if, Matilda survived the decedent. If Matilda predeceased, the bequest would lapse, and Matilda's estate would take nothing.

If the decedent had intended for Matilda's issue to benefit in the event Matilda predeceased, then the following language might have been employed:

I leave the sum of \$50,000 to Matilda, if she survives me, or if not, to her issue, *per stirpes*.

The term *per stirpes* is latin for "by the root." Assume Matilda bore three children, one of whom predeceased her, leaving two children. In that case, Matilda's bequest would be divided into thirds. Her two surviving children would each take a third, and

her two grandchildren (from the predeceasing child) would each take one-sixth (half of her predeceasing child's one-third share).

The will might also have provided that the bequest be made

to Matilda if she survives me, or if not, to her issue, *per capita*.

The term *per capita* is latin for "by the head." Assume again that Matilda bore three children, one of whom predeceased her leaving two children. Here, the bequest would be divided into four, with Matilda's two children each taking one-fourth, and Matilda's two grandchildren each taking one-fourth. Few testators choose *per capita* dispositions.

The will could also generally provide for the issue of Matilda in the event Matilda predeceased, without specifying whether the bequest was *per stirpes*, or *per capita*. Such a bequest could be made in the following way:

I leave the sum of \$50,000 to Matilda if she survives me, or if not, to her issue.

In this case, the issue would take by "representation." Assume Matilda had three children, two of whom predeceased. One predeceasing child bore one child, and the other predeceasing child had nine children. Matilda's surviving child would take one-third, the same amount the child would take if the bequest had been *per stirpes*.

However, something else happens at the generational level of the grandchildren: Each grandchild would take a one-tenth share of the two-thirds not passing to Matilda's surviving child. Thus, the bequest could be thought of as *per stirpes* at the children's level, and *per capita* at the second generation level, that of the grandchildren. Notice that Matilda's surviving child will receive the same as she would have received had her

siblings not predeceased Matilda. Yet, also notice that the grandchildren are not taking "by the root," but rather "by the head."

Of course, it would also be perfectly appropriate if the will provided that the grandchildren would take by representation if Matilda and at least one of her children predeceased. In that case, the will would state

I leave \$50,000 to Matilda, if she survives me, or if not, by right of representation.

If the \$50,000 bequest were made to Matilda out of a specified Citibank account, Matilda would receive the \$50,000 if and only if (i) the Citibank account existed at Matilda's death and (ii) the account had sufficient assets to satisfy the bequest. If the account no longer existed, the bequest would "adeem". If the account existed but had insufficient funds, the bequest would "lapse" to the extent of the deficiency.

A bequest may also be made of intangible personal property, such as a bank or brokerage account. The same rules apply to such bequests: If the bank account is no longer in existence, then the bequest will have adeemed, since it is no longer in existence at the time of the decedent's death.

Bequests of items of tangible personal property would be made in the following way:

I leave my antique Chinese vase to my son Albert, if he survives me, or if not, to my daughter Ellen.

Here, if Albert predeceased, then the vase would go to Ellen, if she survived. If both predeceased, the vase would go to the estate of Ellen, pursuant to the terms of her will. If her will were silent concerning the vase, it would be disposed of pursuant to her residuary estate. If Ellen died intestate, the vase would go to Ellen's heirs at law. If Ellen died leaving no heirs, the

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**THE DECEDENT'S LAST WILL, CONT.**

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vase would “escheat” to New York. Escheat means that the property reverts to the state or sovereign.

Many are of the belief that if they die intestate, all of their property escheats to the state. Nothing could be more untrue. Dying without a will is disadvantageous for many reasons, however, dying intestate simply means that the estate will pass to the decedent's heirs at law. For some testators without closely related heirs, this might be a fate worse than the property reverting to the state. Often, wealthy persons without close heirs make large charitable bequests, rather than have their estate claimed by distant heirs whom they may not even know of.

Naturally, if the testator owns two Chinese vases, the vase which is the subject of the bequest should be identified with particularity to avoid problems of identification for the Executor. Typically, the Executor will be given “unreviewable discretion” with respect to these determinations, as well as most other determinations requiring the Executor's discretion when administering the decedent's estate.



## ASSET PROTECTION, CONT.

(Continued from page 1)

tered into with the intent to delay, hinder or defraud creditors and others of their just and lawful claims.

The Statute provided that such conveyances were “clearly and utterly void, frustrate and of no effect” as against “creditors and others” whose claims might be hindered by such conveyances.

Today, as in the Middle Ages, conveyances which defeat claims of existing creditors may be challenged as being fraudulent. Asset protection is the “good witch” of asset transfers, wherein one legitimately arranges one’s assets so as to render them impervious to creditor attack. Asset protection is best implemented before a creditor appears, since a transfer made with the intent to hinder, delay or defraud a creditor may be deemed a fraudulent conveyance subject to rescission. Asset protection in its most elementary form might consist of merely gifting or consuming the asset.

Gifts made outright or to an irrevocable trust provide asset protection, assuming the transfer is *bona fide*. In property law, a gift requires three elements: First, the donor must *intend* to make a gift. Second, the donor must *deliver* the gift to the donee. Third, the donee must *accept* the gift. Whether these requirements have been met is a question of local law. (Although the IRS has dispensed with the requirement of donative intent to impose gift tax, most courts have not.)

Gifts should be delivered and be evidenced by a writing. Although transfers to family members are presumed to have donative intent, creditors may argue that the donee family member is merely holding legal title in trust or as nominee for the donor. For this reason, intrafamily gifts should be evidenced by a formal writing in which the donee accepts the gift.

Delivery of personal property should be accompanied by a written instrument. Delivery of real property requires a deed, and delivery of intangible personal property should be ac-

companied by an assignment or other legal document. Ownership of some intangibles, such as securities, may be accomplished by registering the securities in the name of the donee.

The retention by the donor of possession of property may suggest the absence of a gift, since no gift occurs where trustee, agent or bailee retains possession of the property. Similarly, asking a family member or a friend to “hold” property to protect against the enforcement of a known judgment creditor’s claim until the threat disappears would be subject to being declared fraudulent, since the motive for the transfer will have lacked donative intent.

Operating a business in corporate form, entering into a prenuptial agreement, executing a disclaimer, or even giving effect to a spendthrift trust provision, are common examples of asset protection which present few legal or ethical issues, primarily because such transfers do not defeat rights of known creditors. However, transferring assets into a corporation solely to avoid a personal money judgment, or utilizing an offshore trust solely to avoid alimony or child support payments, would defeat the rights of legitimate creditors, and would thereby constitute fraudulent transfers.

Businesses have traditionally limited exposure to liability by forming corporations. The limited liability of corporate shareholders has existed since 1602 when the Dutch East India Company was chartered to engage in spice trade in Asia. Yet the liability protection offered by corporate form can be negated, and the corporate veil “pierced,” if the corporation is undercapitalized.

Other business entities, such as LLCs and partnerships, also offer asset protection. Claims made against these entities, like claims made against corporations, do not “migrate” to the member or partner. A judgment creditor of a partner cannot seize the debtor’s partnership interest, but is limited to obtaining a “charging order.” A charging order is a lien against the partner’s partnership interest.

A judgment creditor holding a charging order “stands in the shoes” of the partner with respect to partnership distributions. Therefore, if the partnership makes no distributions, the judgment creditor who has seized the partner’s interest may be charged with “phantom” income. This may cause the value of the creditor’s claim to be greatly diminished.

Disclaimers may be effective in avoiding creditor claims and are generally not fraudulent transfers under New York law. In New York, one may validly disclaim property and may thereby place the asset beyond the reach of creditors. The IRS may reach disclaimed property to satisfy a federal tax lien.

Certain powers of appointment possess asset protection features. Limited powers of appointment are beyond creditors’ claims since the power holder has no beneficial interest in the power. Presently exercisable general powers of appointment, by contrast, in New York at least, are subject to creditors claims since the power holder has the right to appoint the property to himself. EPTL § 10-7.2.

## II. Ethical Considerations

Ethical considerations reach their zenith when asset protection is being contemplated. The obligation of an attorney to zealously represent the interests of his client is unquestioned. The ABA Model Code of Professional Conduct, DR 7-101, “Representing a Client Zealously,” provides that

A lawyer shall not intentionally fail to seek lawful objectives of his client through reasonable available means permitted by law and the Disciplinary Rules.

The Second Circuit has held that “[a] lawyer is authorized to practice his profession, to advise his clients, and to interpose any defense or supposed defense without making himself liable for damages.” *Newburger, Loeb & Co. v. Gross*, 563 F.2d

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1057, 1080 (2<sup>nd</sup> Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978).

Nevertheless, the ABA Model Code of Professional Conduct, DR 7-102, "Representing a Client Within the Bounds of the Law," provides that "[a] lawyer shall not . . . [c]ounsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent."

Although the Model Code does not define "fraud," New York, a Model Code jurisdiction, has provided that the term

does not include conduct, although characterized as fraudulent by statute or administrative rule, which lacks an element of scienter, deceit, intent to mislead, or knowing failure to correct misrepresentations which can be reasonably expected to induce detrimental reliance by another.

Therefore, in New York, the prohibition against counseling a client in perpetrating a "fraud" would apparently not prohibit an attorney from assisting a client in transferring property because of the possibility that the transfer might, in hindsight, be determined to have constituted a fraudulent conveyance.

Model Rule 8.4 of the ABA Model Rules of Professional Conduct provides that it is professional misconduct for a lawyer to "engage in conduct involving dishonesty, fraud, deceit or misrepresentation." Model Rule 4.4 provides that "a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person."

Conduct involving dishonesty or an attempt to deceive appears to be a readily determinable question of fact. However, conduct employing means having no substantial purpose other than to delay or burden third parties may be a more difficult factual determination.

Connecticut Informal Opinion 91-23 states that

[f]raudulent transfers delay and burden those creditors who would be in-

clined to try and satisfy their unpaid debts from property of the debtor. It forces them to choose either not to challenge the transfer and suffer the loss of an uncollected debt or to file an action to set aside the transfer...If there is no other substantial purpose, Rule 4.4 applies. Where there is another substantial purpose, Rule 4.4 does not apply. For example, where there is a demonstrable and lawful estate planning purpose to the transfer Rule 4.4 would not, in our view apply.

An attorney is therefore ethically and legally permitted to provide counsel in the protection of a client's assets. Since most prohibitions on attorneys involve the attorney having acted "knowingly," due diligence is important to avoid ethical or legal problems. The counselor should determine (i) the source of the client's wealth; (ii) the client's reason for seeking advice concerning asset protection; and (iii) whether the client has any current creditor issues or is merely insuring against as yet unknown future creditor risks.

The client is also under an obligation to be truthful. Accordingly, the client should affirm that (i) it has no pending or threatened claims; (ii) it is not under investigation by the government; (iii) it will remain solvent following any intended transfers; and (iv) it has not derived from unlawful activities any of the assets to be transferred.

### III. Uniform Fraudulent Transfer & Conveyance Acts

The definition of fraudulent transfer has remained fairly constant since the Statute of Elizabeth. While the common law doctrine of *res judicata* has influenced domestic courts in interpreting the common law of fraudulent conveyances, most states have chosen to codify the law. The *Uniform Fraudulent Transfer Act* defines the term "transfer" as

every mode, direct or indirect, absolute or conditional, voluntary or in-

voluntary, of disposing of or parting with an asset or an interest in an asset, and includes the payment of money, release, lease, and creation of a lien or other encumbrance.

The Uniform Fraudulent Conveyance Act, the successor to the Uniform Fraudulent Transfer Act, defines a creditor as "a person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent." The Act defines the term "claim" as "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." (New York is among six states that have enacted the Uniform Fraudulent Transfer Act, but not the Uniform Fraudulent Conveyance Act.)

### IV. Decisional Law

Although ample statutory authority exists, courts are often called upon to apply the common law in decide whether a conveyance is fraudulent. The doctrine of *stare decisis*, which recognizes the significance of legal precedent, plays a paramount role in the evolving law governing asset transfers.

The Supreme Court, in *Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, held that an owner of property has an almost absolute right to dispose of that property, provided that the disposition does not prejudice existing creditors. Federal courts are without power to grant pre-judgment attachments since (i) legal remedies must be exhausted prior to equitable remedies; and (ii) a general (pre-judgment) creditor has no "cognizable interest" that would permit the creditor to interfere with the debtor's ownership rights.

In determining whether a transfer is fraudulent, New York courts have made a distinction between future and existing creditors. *Klein v. Klein*, 112 N.Y.S.2d 546 (1952) held

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that the act of transferring title to the spouse of a police officer to eliminate the threat of a future lawsuit against the officer arising by virtue of the nature of his office was appropriate, and “amounted to nothing more than insurance against a possible disaster.”

Similarly, in *Pagano v. Pagano*, 161 Misc.2d 369, 613 N.Y.S.2d 809 (N.Y. Sur. 1994), family members transferred property to another family member who was not engaged in business. The Surrogate found there was no fraudulent intent and that

transfers made prior to embarking on a business in order to keep property free of claims that may arise out of the business does not create a claim of substance by a future creditor.

The New York County Surrogates Court, in *In re Joseph Heller Inter Vivos Trust*, 613 N.Y.S.2d 809 (1994), approved a trustee’s application to sever an *inter vivos* trust for the purpose of

insulat[ing] the trust’s substantial cash and securities from potential creditor’s claims that could arise from the trust’s real property.

The Surrogate observed that

New York law recognizes the right of individuals to arrange their affairs so as to limited their liability to creditors, including the holding of assets in corporate form...making irrevocable transfers of their assets, outright or in trust, as long as such transfers are not in fraud of existing creditors.

## V. Establishing Fraudulent Intent

Intent is subjective and proving it is difficult. Direct evidence of fraudulent intent, such as an email or a tape, is not likely to exist. Courts have therefore resorted to circumstantial evidence in the form of “badges of fraud.” Whether badges of fraud exist is determined by assessing (i) the solvency of the debtor immediately fol-

lowing the transfer; (ii) whether the debtor was sued or threatened with suit prior to the transfer; and (iii) whether the debtor transferred property to his or her spouse, while retaining the use or enjoyment of the property.

Under NY Debt. & Cred. Law § 273-a, a conveyance made by a debtor against whom a money judgment exists is presumed to be fraudulent if the defendant fails to satisfy the judgment. Transfers in trust at one time were, but are no longer, considered a badge of fraud. However, transfers in trust may implicate a badge of fraud if the transferor retains enjoyment of the transferred property.

Once the existence of a fraudulent transfer has been established, the Uniform Fraudulent Transfer Act provides that the creditor may (i) void the transfer to the extent necessary to satisfy the claim; (ii) seek to attach the property; (iii) seek an injunction barring further transfer of the property; or, if a claim has already been reduced to judgment, (iv) levy on the property. Under the Act, “a debtor is insolvent if the sum of the debtor’s debts is greater than all of the debtor’s assets at a fair valuation.”

Warning signs that a transfer may be fraudulent include insolvency of the transferor, lack of consideration for the transfer, and secrecy of the transaction. Insolvency, for this purpose, means that the transfer is made when the debtor was insolvent or would be rendered insolvent, or is about to incur debts he will not be able to pay.

Debtor & Creditor Law, Sec. 275 provides that “[e]very conveyance and every obligation incurred without fair consideration [with an intent to] incur debts beyond ability to pay...is fraudulent.” However, once the determination has been made that the transfer is not fraudulent, later events which might have rendered the transaction fraudulent would be of no legal moment.

The transfer of assets by a person against whom a meritorious claim has been made — even if not reduced to judgment — could render the

transfer voidable. If the claim is not meritorious, then the transfer would probably not be fraudulent, regardless of its eventual disposition. For example, transferring title in the marital residence to a spouse could be a valid asset protection strategy, but doing so immediately after the IRS has filed a tax lien would likely result in the IRS seeking to void the transfer. However, if the IRS tax lien was erroneously filed, then the IRS could not properly seek to vitiate the transfer.

Gratuitous transfers are susceptible to being characterized as fraudulent in cases where the transferor appears to remain the equitable owner of the property. Accordingly, transfers between or among family members, or transfers to a partnership for little or no consideration, may carry with them the suggestion of fraudulent intent. In this vein, even a legitimate sale, if evidenced only by a flimsy, hastily prepared document, suggests an element of immediacy or unenforceability, which could in turn support a finding of fraud.

## VI. Asset Protection in Marriage

New York recognizes the existence of “separate” as well as “marital” property in the estate of marriage. Neither the property nor the income from separate property may be seized by a creditor of one spouse to satisfy the debts of the other spouse. Therefore, property may properly be titled or retitled in the name of the spouse with less creditor risk. Provided the transfer creating separate property is made before the assertion of a valid claim, creditors of the transferring spouse should be prevented from asserting claims against the property.

In contrast to protection afforded by separate property, marital property is subject to claims of creditors of either spouse. Whether property constitutes marital property or separate property may involve tracing the flow of money or property. Property received by gift or inheritance is separate property, and is generally protect-

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ed from claims made against the other spouse (or from claims made by the other spouse). Combining separate property or funds of the spouses will transform separate property into marital property.

Common law recognizes the right of married persons to enjoy enhanced asset protection if title is held jointly between the spouses in a tenancy by the entirety, a unique form of title available only to married persons. *U.S. v. Gurley*, 415 F.2d 144, 149 (5th Cir. 1969) observed that “[a]n estate by the entireties is an almost metaphysical concept which developed at the common law from the Biblical declaration that a man and his wife are one.”

First codified in 1896, EPTL § 6-2.2 recognizes the tenancy by the entirety, where title is vested in the married couple jointly and each spouse possesses an undivided interest in the entire property. Provided the couple remains married, the survivorship right of either spouse cannot be terminated. Nor may spouse can unilaterally sever or sell his or her portion without the consent of the other. However, divorce will automatically convert a tenancy by the entirety to a joint tenancy.

The ability to prevent creditors of one spouse from reaching, attaching and possibly selling marital property held in a tenancy by the entirety is a unique and important attribute of the marital estate. Creditors cannot execute a judgment on property held by spouses in a tenancy by the entirety. New York cases have held that a receiver in bankruptcy cannot reach or sever ownership when title is by the entirety. Although coop ownership is technically the ownership of securities and not real estate, ownership by married couples of coops as tenants by the entirety is now the default method of holding title in a coop.

Not all property held in a tenancy by the entirety is protected from claims of creditors. The IRS, a creditor with enhanced rights, has succeeded in defeating the protection normally ac-

corded by holding property in a tenancy by the entirety. In *Craft v. U.S.*, 535 U.S. 274 (2002), the Supreme Court held that a federal tax lien could attach even to an interest held by one spouse as a tenant by the entirety.

Marriage may also present situations where the spouses themselves assume a creditor and debtor relationship. Prenuptial and postnuptial agreements define the rights and obligations of spouses between themselves, both during and after a divorce. Many statutory rights may be waived, changed or enhanced by agreement. Other rights not provided by statute may be conferred upon a party by a pre or postnuptial agreement.

A prenuptial agreement may attempt to alter the rights of persons not a party to the agreement. Thus, parties could designate certain property as separate property in the event of a divorce. However, such an executory contract (*i.e.*, not performed) would not necessarily be binding on a third party, and might be successfully avoided, for example, by a trustee in bankruptcy.

Some retirement benefits, such as IRA benefits, may be waived in a prenuptial agreement. However, retirement benefits subject to ERISA may not be waived prior to marriage. If a waiver of ERISA benefits is contemplated in a prenuptial agreement, the agreement should contain a provision requiring the waiving party to execute a waiver after marriage. If the waiver does not occur following marriage, the waiver of retirements benefits subject to ERISA will be ineffective.

## VII. Joint Tenancies and Tenancies in Common

Joint tenancies and tenancies in common offer little asset protection. The joint tenancy is similar to a tenancy by the entirety in that each joint tenant owns an undivided interest, and each possesses the right of survivorship. However, unlike property held by spouses as tenants by the entirety, each joint tenant may pledge or transfer his interest without the consent of

the other, since there is no “unity of ownership.” Such a transfer would create a tenancy in common.

Another distinction between the tenancy by the entirety and the joint tenancy is that a joint tenant’s interest is subject to attachment by creditors and by the Bankruptcy Court. If attachment occurs, the joint tenancy can be terminated and the property can be divided or, more likely, partitioned, with the proceeds being divided between the unencumbered joint tenant and the creditor or trustee in bankruptcy. Note that although a tenancy by the entirety is presumed to be the manner in which married persons hold title, married persons may also hold title as joint tenants, or as tenants in common.

For this reason, deeds should be clear as to the type of tenancy in which the property owned by spouses is being held. A deed stating that title is held by “husband and wife, as joint tenants,” would imply the existence of a joint tenancy but, because of the phrase “husband and wife,” could also be interpreted as creating a tenancy by the entirety.

The tenancy in common provides little asset protection. Each tenant in common is deemed to hold title to an undivided interest in the property that each may dispose of by sale, gift or bequest. No right of survivorship exists, nor is there a unity of ownership, as in a tenancy by the entirety. Tenants in common share a right of possession. Thus, one tenant in common could transfer an interest in real property to a third party who could demand concurrent possession. An unwilling tenant in common could prevent such an eventuality by forcing a partition sale.

The interest of a debtor tenant in common is subject to attachment by judgment creditors and the Bankruptcy Court. The only real asset protection accorded by the tenancy in common is the time and expense a creditor would be required to expend in commencing a partition sale to free up liquidity in the property seized.

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**VIII. Protecting The Residence**

New York affords little protection to the homestead against claims made by creditors. CPLR 5206(a) provides that amount of equity in the debtor's homestead shielded from judgment creditors and from the bankruptcy trustee is \$50,000. Married couples in co-ownership may each claim a \$50,000 exemption where a joint bankruptcy petition is filed, creating a \$100,000 exemption.

Although little statutory protection is provided for by the legislature, the Department of Taxation and Finance has shown little inclination to foreclose on a personal residence of a New York resident to satisfy unpaid tax liabilities. The IRS, perhaps reflecting its federal charter, has shown slightly less disinclination to foreclose in this situation, although in fairness it should be noted that the IRS infrequently commences foreclosure proceedings on a residence to satisfy a tax lien. On the other hand, both the IRS and New York State could be expected to record a tax lien which would secure the government's interest in the event the property were sold or refinanced.

Some states, such as Florida and Texas, provide for a liberal homestead exemption. The homestead exemption in Florida is unlimited, provided the property is no larger than one-half acre within a city, or 160 acres outside of a municipality. The Florida Supreme Court has held that the homestead exemption found in Florida's Constitution even protects homes purchased with nonexempt funds for the purpose of defrauding creditors in violation of Florida statute. *Havoco of America, Ltd., v. Hill*, 790 So.2d 1018 (Fla. 2001).

Since a residence is often a significant family asset, in jurisdictions such as Florida, the debtor's equity in the homestead may be increased to a large amount. This protection was availed of by Mr. Simpson after a large civil judgment was rendered

against him in California.

In jurisdictions such as New York, which confer little protection to the residence, a qualified personal residence trust (QPRT) may serve as a proxy. A QPRT results when an interest in real property, which could be attached by a creditor, is converted into a mere right to reside in the residence for a term of years. A (QPRT) is often used to maximize the settlor's unified credit for estate planning purposes.

The asset protection feature of a QPRT derives directly from the diminution of rights in the property retained by the putative debtor-to-be. The asset protection benefit of creating a QPRT is that the settlor's interest in the property is changed from a fee interest subject to foreclosure and sale, to a right to continue to live in the residence, which is not. If the settlor's spouse has a concurrent right to live in the residence, a creditor would probably have no recourse. Some litigation involving QPRT property has arisen in New York.

**IX. Federal Bankruptcy Exemptions**

Under Section 522 of the Federal Bankruptcy Code, certain "exempt" items will be unavailable to creditors in the event of bankruptcy. Individual states are given the ability to "opt out" of the federal exemption scheme, or to permit the debtor to choose the federal exemption scheme or the state's own exemption statute. New York has chosen to require its residents to opt out of the federal scheme, and has provided its own set of exemptions. Nevertheless, some exemptions provided for by federal law cannot be overridden by state law.

Exemptions found in federal law also occur outside of the Federal Bankruptcy Code may also be used by a debtor. These include (i) wage exemptions; (ii) social security benefits; (iii) civil service benefits; (iv) veterans benefits; and (v) qualified plans under ERISA. Thus, federal bankruptcy law automatically exempts virtually all tax-exempt pensions and retirement savings accounts from bankruptcy, even if

state law exemptions are used.

Federal law protects any pension or retirement fund that qualifies for tax treatment under IRC Sections 401, 402, 403, 408, or 408A. IRAs qualify under IRC § 408. Qualified plans under ERISA enjoy special asset protection status. Under the federal law, funds so held are protected from creditors of the plan participant. *Patterson v. Shumate*, 504 U.S. 753 (1992). The protection offered by federal statute is paramount, and may not be diminished by state spendthrift trust law.

**X. New York Exemptions**

The objective in pre-bankruptcy planning is to make maximum use of available exemptions. At times, this involves converting non-exempt property into exempt property. While pre-bankruptcy planning could itself rise to the level of a fraud against existing creditors, since the *raison d'être* of exemptions is to permit such planning, only in an extreme case would an allegation of fraud likely be upheld.

New York has in some cases legislated permissible exemption planning by providing windows of time in which pre-bankruptcy exemption planning is permissible. Under ERISA, most qualified plans are required to include a spendthrift provision. Accordingly, most qualified plans will be asset protected with respect to state law proceedings, and will be excluded from the debtor's bankruptcy estate. See CPLR § 5205(c), Debt. & Cred. Law § 282(2)(e).

New York (as well as New Jersey and Connecticut) exempts 100 percent of undistributed IRA assets. Non-rollover IRAs are exempt from being applied to creditors' claims pursuant to CPLR 5205, which denotes them as personal property.

EPTL §7-1.5(a)(2) provides that proceeds of a life insurance policy held in trust will not be "subject to encumbrance" provided the trust agreement so provides. Similarly, Ins. Law §3212(b) protects life insurance pro-

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ceeds provided the trust contains language prohibiting the proceeds from being used to pay the beneficiary's creditors. Ins. Law §3212(c) protects life insurance proceeds if the beneficiary is not the debtor, or if the debtor's spouse purchases the policy.

Ins. Law §3212(d) at first blush is appealing, as it provides for an unlimited exemption for benefits under an annuity contract. However, upon closer examination paragraph (d)(2) further provides that "the court may order the annuitant to pay to a judgment creditor . . . a portion of such benefits that appears just and proper . . . with due regard for the reasonable requirements of the judgment debtor."

Debt. & Cred. Law §283(1) circumscribes the protection accorded to annuities, by limiting the exemption for annuity contracts purchased within six months of a bankruptcy filing to \$5,000, without regard to the "reasonable income requirements of the debtor and his or her dependents."

CPLR §5205(d) provides that the following personal property is exempt from application to satisfy a money judgment, except such part as a court determines to be unnecessary for the reasonable requirements of the judgment debtor and his dependents:

(i) ninety percent of the earnings of the judgment debtor for personal services rendered within sixty days before, and any time after, an income execution. (Since the exemption applies to employees, income derived from self-employment may not be excluded);

(ii) ninety percent of income or other payments from a trust the principal of which is not self-settled;

(iii) payments made pursuant to an award in a matrimonial action for support of the spouse or for child support, except to the extent such payments are "unnecessary"; and

(iv) property serving as collateral for a purchase-money loan (e.g., car loan or a home securing a first mortgage) in an action for repossession.

sion.

## XI. Trusts

The concept of trusts dates back to the 11th Century, at the time of the Norman invasion of England. Trusts emerged under the common law as a device which minimized the impact of inheritance taxes arising from transfers at death. The purpose of the trust was to separate "legal" title, which was given to the "trustee," from "equitable title," which was retained by the trust beneficiaries. Since legal title remained in the trustee at the death of the grantor, transfer taxes were thus avoided.

The trust has since evolved in common law countries throughout the world. Trusts today serve myriad functions including, but not limited to, the function of reducing estate taxes. The basic structure of a trust is that (i) a settlor (either an individual or a corporation), establishes the trust agreement; (ii) the trustee takes legal title to and administers the assets transferred into the trust; and (iii) beneficiaries receive trust distributions.

Trusts are ubiquitous in estate planning, both for nontax as well as tax reasons. For example, trusts are employed as a means to protect immature or spendthrift beneficiaries. *Inter vivos* trusts also enable the grantor to retain considerable control over the trust property. Testamentary trusts contained in wills enable the testator to control the manner in which the estate will be distributed to heirs.

Trusts also possess significant asset protection attributes. Since trusts may be employed for diverse and legitimate reasons, they are not typically thought of as a device employed with an intent to hinder, delay or defraud creditors. However effective trusts are at protecting against creditor claims, once trust assets are distributed to beneficiaries, the beneficiary holds legal title to the property. At that point, creditor protection may be lost.

Asset protection features of an irrevocable trust may arise by virtue of a discretionary distribution provision,

also known as a "sprinkling" trust. For example, the trust may provide that the trustees

in their sole and absolute discretion may pay or apply the whole, any portion, or none of the net income for the benefit of the beneficiaries.

Alternatively, the trustees' discretion may be limited by a broadly defined standard, *i.e.*,

so much of the net income as the Trustees deem advisable to provide for the support, maintenance and health of the beneficiary.

The effects of a discretionary distribution provision on the rights of a creditor are profound. The rights of a creditor can be no greater than the rights of a beneficiary. Therefore, if the trust provides that the beneficiary cannot compel the trustee to make distributions, neither could the creditor force distribution. Therefore, properly limiting the beneficiary's right to income in the trust instrument may determine the extent to which trusts assets are protected from the claims of creditors.

Failure to properly limit the beneficiary's right to income from a trust can also have deleterious tax consequences if the creditor is the IRS. TAM 0017665 stated that where the taxpayer had a right to so much of the net income of the trust as the trustee determined necessary for the taxpayer's "health, maintenance, support and education," the taxpayer had an identifiable property interest subject to a federal tax lien. Since the discretion of the trustee was broadly defined and subject to an "ascertainable standard" rather than being absolute, the asset protection of the trust was diminished.

A trustee who is granted absolute discretion in the trust instrument to make decisions regarding trust distributions, and who withholds distributions to a beneficiary with a judgment creditor, is not acting fraudulently *vis à vis* the creditor. To the contrary, the

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trustee is properly fulfilling his fiduciary responsibilities. However, in some cases, a court may compel a trustee to make distributions. In such cases, the trustee could be faced with possible contempt if he refused to comply with the court's order. To make the trustee's office even more difficult, the trustee could be faced with competing directives from *different* courts.

Many settlors choose to incorporate mandatory distribution provisions which provide for outright transfers to children or their issue at pretermained ages. Yet, holding assets in trust for longer periods may be preferable, since creditor protection can then be continued indefinitely. Holding a child's interest in trust for a longer period may be prudent in a marriage situation. Assets held in a trust funded either by the spouse or by the parent stand a greater chance of being protected in the event of divorce than assets distributed outright to the spouse, even if the beneficiary-spouse does not "commingle" these separate assets with marital assets.

If the trust provides for a distribution of principal upon the beneficiary's reaching a certain age, *e.g.*, 35 or 40, the inclusion of a "hold-back" provision allowing the Trustee to withhold distributions in the event a beneficiary is threatened by a creditor claims, may be advisable.

**XII. Implied Trusts**

Express trusts are those which are memorialized and formally executed. However, trusts may also be implied in law. An implied "resulting trust" arises where the person who transfers title also paid for the property, and it is clear from the circumstances that such person did not intend to transfer beneficial interest in the property. Parol evidence may be used to demonstrate the existence of a resulting trust.

Thus, a parent who makes car payments under a contract in the child's name will not hold legal title,

but would likely possess equitable title. Since creditors of the parent "stand in the shoes" of the parent, they might be capable of asserting rights against the child who holds "bare" legal title. Even if the child had no knowledge of the parent's creditor, the creditor could be entitled to restitution of the asset. *Rogers v. Rogers*, 63 NY2d 582, 483 NYS2d 976 (1984).

A "constructive trust" arises where equity intervenes protect the rightful owner from the holder of legal title, where legal title was acquired through fraud, duress, undue influence, mistake, breach of fiduciary duty, or other wrongful act, and the wrongful owner is unjust enriched. In New York, a constructive trust requires the following four conditions: (i) a fiduciary or confidential relationship; (ii) a promise; (iii) a transfer in reliance on the promise; and (iv) unjust enrichment.

A transfer made to avoid an obligation owed to a creditor will constitute a fraudulent transfer. In many cases, no consideration will have been paid to a transferee who agrees to hold legal title for the transferor to avoid the claims of the transferor's creditor. If the scheme is not uncovered, and the transferor attempts to regain title from the transferee, a constructive trust would in theory arise, since the four conditions for establishing a constructive trust would exist.

However, the constructive trust is an equitable remedy. Courts sitting in equity are generally loathe to allow one with "unclean hands" to profit. Therefore, most courts would refuse to imply a trust in favor of the transferor where the transfer was made for illegal purposes. However, the same court might well imply a constructive trust in favor of the legitimate creditors of the transferor in this case.

Occasionally, a person will establish a "mirror" trusts with another person, hoping to achieve asset protection by indirect means. However, such arrangements are likely to fail. Thus, "reciprocal" or "crossed" trust arrangements, in which the settlor

of one trust is the beneficiary of another, would likely offer little or no asset protection. In fact, the "reciprocal trust doctrine" has been invoked by the IRS to defeat attempts by taxpayers to shift assets out of their estates.

**XIII. Tax Issues Associated with Asset Protection Trusts**

It is inadvisable for the settlor to name himself as trustee of an irrevocable trust, unless the settlor has retained virtually no rights under the trust. The settlor's retained right to determine beneficial enjoyment could well cause estate tax inclusion under IRC §§ 2036 and 2038. However, a settlor will not be deemed to have retained control for estate tax purposes merely because the trustee is related to the settlor. Therefore, the settlor's spouse or children may be named as trustees without risking estate tax inclusion.

To avoid estate tax problems for a beneficiary named as trustee, the powers granted to the beneficiary should be limited. A beneficiary's right to make distributions to herself without an ascertainable standard limitation would constitute a general power of appointment under Code Sec. 2041, and would result in inclusion in the beneficiary's estate. The beneficiary's power to make discretionary distributions would also decimate creditor protection. To avoid this problem, an independent trustee should be appointed to exercise the power to make decisions regarding distributions to that beneficiary.

EPTL §10-10.1 prevents inadvertent estate tax fiascos by statutorily prohibiting a beneficiary from making decisions regarding discretionary distributions to himself. Therefore, even if the beneficiary were named sole trustee of a trust providing for discretionary distributions, the statute would require another trustee to be appointed to determine distributions to the beneficiary. Note

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that in this case the beneficiary could continue to act as trustee for other purposes of the trust, and could continue to make decisions regarding distributions to other beneficiaries.

If the beneficiary has unlimited right to the trust, regardless of who is the trustee, inclusion could result under IRC § 2036. It is the retained *right* -- and not the actual distribution -- that causes inclusion. PLR 200944002 stated that a trustee's authority to make discretionary distributions to the grantor will not by itself result in inclusion under IRC § 2036. Thus, a trust which grants the trustee the authority to make distributions to the settlor, but vests in the settlor no rights to such distributions, might result in IRC § 2036 problems being avoided.

**XIV. Spendthrift Trusts**

Trust assets can be placed beyond the reach of beneficiaries' creditors by use of a "spendthrift" provision. The Supreme Court, in *Nichols v. Eaton*, 91 U.S. 716 (1875), recognized the validity of a spendthrift trust, holding that an individual should be able to transfer property subject to certain limiting conditions.

A spendthrift clause provides that the trust estate shall not be subject to any debt or judgment of the beneficiary, thus preventing the beneficiary from voluntarily or involuntarily alienating his interest in the trust. The rationale behind the effectiveness of a spendthrift provision is that the beneficiary possesses an equitable, but not a legal, interest in trust property. Therefore, creditors of a beneficiary should not be able to assert legal claims against the beneficiary's equitable interest in trust assets.

Even if the trust instrument provides that the trustee's discretion is absolute, the trust should contain a spendthrift clause. It is not enough for asset protection purposes that a creditor be unable to compel a distribution. The creditor must also be unable to attach the beneficiary's

interest in the trust.

A spendthrift trust may protect a beneficiary from (i) his own profligacy or immaturity; (ii) his bankruptcy; (iii) some of his torts; (iv) many of his creditors; and (v) possibly his spouse. No specific language is necessary to create a spendthrift trust. A spendthrift limitation may even be inferred from the intent of the settlor. Still, it is preferable as well as customary to include spendthrift language in a trust.

A spendthrift provision may also provide that required trust distributions become discretionary upon the occurrence of an event or contingency specified in the trust. Thus, a trust providing for regular distributions to beneficiaries might also provide that such distributions would be suspended in the event a creditor threat appears. Most wills containing trusts incorporate a spendthrift provision.

Some exceptions to spendthrift trust protection are in the nature of public policy exceptions. Thus, spendthrift trust assets may be reached to enforce a child support claim against the beneficiary. Courts could also invalidate a spendthrift provision to satisfy a judgment arising from an intentional tort. A spendthrift trust would likely be ineffective against a government claim relating to taxes, since public policy considerations in favor of the collection of tax may outweigh the public policy of enforcing spendthrift trusts.

**XV. Self-Settled Spendthrift Trusts**

At common law, a settlor could not establish a trust for his own benefit, thereby insulating trust assets from claims of own creditors. Such a "self-settled" spendthrift trust would arise where the person creating the trust also names himself a beneficiary of the trust. Under common law, the assets of such a trust would be available to satisfy creditor claims to the same extent the property interest would be available to the person

creating the trust. Thus, one could not fund a trust with \$1,000, name himself as sole beneficiary, and expect to achieve creditor protection. This is true whether or not the settlor also named himself as trustee.

Prior to 1997, neither the common law nor the statutory law of any state permitted a self-settled trust to be endowed with spendthrift trust protection. However, since 1997, five states, including Delaware and Alaska, have enacted legislation which expressly authorizes self-settled spendthrift trusts. If established in one of these jurisdictions, a self-settled spendthrift trust could allow an individual to put assets beyond the reach of future, and in some cases even existing, creditors while retaining the right to benefit from trust assets.

These few states now compete with exotic locales such as the Cayman and Cook Islands, and with less exotic places, such as Bermuda and Lichtenstein, which for many years have been a haven for those seeking the protection that only a self-settled spendthrift trust can offer.

New York is not now, and has never been, a haven for those seeking to protect assets from claims of creditors. Most states, including New York, continue to abhor self-settled spendthrift trusts. This is true even if another person is named as trustee and even the trust is not created with an intent to defraud existing creditors. New York's strong public policy against self-settled spendthrift trusts is evident in EPTL § 7-3.1, which provides:

A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator.

Still, there appears to be no reason why a New York resident could not transfer assets to the trustee of a self-settled spendthrift trust formed in Delaware or in another state which now permits such trusts. Even though

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a New York Surrogate or Supreme Court judge might view with skepticism an asset protection trust created in Delaware invoked to protect against judgments rendered in New York, the Full Faith and Credit Clause of the Constitution could impart significant protection to the Delaware trust.

If a self-settled spendthrift trust is asset protected, the existence of creditor protection would also likely eliminate the possibility of estate inclusion under IRC §2036. This is so because assets placed beyond the reach of creditors are generally also considered to have been effectively transferred for federal transfer tax purposes.

#### XVI. Delaware Asset Protection Trusts

In 1997, Delaware enacted the “Qualified Dispositions in Trust Act.” Under the Act, a person may create an irrevocable Delaware trust whose assets are beyond the reach of the settlor’s creditors. However, the settlor may retain the right to receive income distributions and principal distributions subject to an ascertainable standard. By transferring assets to a Delaware trust, the settlor may be able to retain enjoyment of the trust assets while at the same time rendering those assets impervious to those creditor claims which are not timely interposed within the applicable period of limitations for commencing an action.

Delaware is an attractive trust jurisdiction for many reasons: First, it has eliminated the Rule Against Perpetuities for real estate; second, it imposes no tax on income or capital gains generated by an irrevocable trust; third, it has adopted the “prudent investor” rule, which accords the trustee wide latitude in making trust investments; fourth, it permits the use of “investment advisors” who may inform the trustee in investment decisions; and fifth, Delaware trusts are confidential, since Delaware courts do not supervise trust administration.

To implement a Delaware trust, a settlor must make a “qualified disposition” in trust, which is a disposition by the settlor to a “qualified trustee” by means of a trust instrument. A qualified trustee must be an individual other than the settlor who resides in Delaware, or an entity authorized by Delaware law to act as trustee. The trust instrument may name individual co-trustees who need not reside in Delaware. Delaware’s statute, 12 Del. C. § 3570 *et seq.*, notes that it “is intended to maintain Delaware’s role as the most favored jurisdiction for the establishment of trusts.”

Although the trust must be irrevocable, the Settlor may retain the right to (i) veto distributions; (ii) exercise special powers of appointment; (iii) receive current income distributions; and (iv) receive principal distributions if limited to an ascertainable standard (*e.g.*, health, maintenance, etc.).

The trust may designate investment advisors and “protectors” from whom the trustee must seek approval before making distributions or investments. Thus, the settlor, even though not a trustee, may indirectly retain the power to make investment decisions and participate in distribution decisions, even to himself.

Delaware trusts may also be structured so that the assets transferred are outside the settlor’s gross estate for estate tax purposes. If, instead of gifting the assets to the trust, a sale is made to a Delaware irrevocable “defective” grantor trust, the assets may be removed from the settlor’s estate at a reduced estate tax cost.

Delaware law governing Delaware trusts is entitled to full faith and credit in other states, a crucial advantage not shared by trusts created in offshore jurisdictions. The Delaware Act bars actions to enforce judgments entered elsewhere, and requires that any actions involving a Delaware trust be brought in Delaware. A New York court might therefore find it difficult to declare a transfer fraudulent if, under Delaware law, it was not. In any

event, a Delaware court would not likely recognize a judgment obtained in a New York court with respect to Delaware trust assets.

Although the Full Faith and Credit Clause of the Constitution requires every state to respect the statutes and judgments of sister states, the Supreme Court, in *Franchise Board of California v. Hyatt*, 538 U.S. 488 (2003) held that it “does not compel a state to substitute the statutes of other states for which its own statutes dealing with a subject matter concerning which it is competent to legislate.” In *Hanson v. Denckla*, 357 U.S. 235 (1958), a landmark case, the Supreme Court held that Delaware was not required to give full faith and credit to a judgment of a Florida court that lacked jurisdiction over the trustee and the trust property.

The Delaware Act does not contain as short a limitations period as do most offshore jurisdictions. Under 12 Del. C. §§ 1304(a)(1) and 3572(b), a creditor’s claim against a Delaware trust is extinguished unless (i) the claim arose *before* the qualified disposition was made and the creditor brings suit within four years after the transfer was made or within 1 year after the transfer was or could reasonably have been discovered by the claimant; or (ii) the creditor’s claim arose *after* the transfer and the creditor brings suit within four years after the transfer, irrespective of the creditor’s knowledge of the transfer.

Although the Delaware statute affords more protection for creditors than do offshore trusts, the four-year period for commencing legal action reduces the risk that a creditor whose claim is time-barred could successfully assert that (i) a transfer was fraudulent notwithstanding the Act or (ii) the Act’s statute of limitations is itself unconstitutional.

A Delaware trust may also continue in perpetuity, at least with respect to real property. By contrast, New York retains the common law Rule Against Perpetuities, which lim-

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its trust duration to 21 years after the death of any person living at the creation of the trust. EPTL § 9-1.1.

**XVII. Foreign Asset Protection Trusts**

The basic structure of an offshore trusts are the same as those of the domestic trust. Foreign trust jurisdictions go beyond Delaware Asset Protection Trusts in terms of the asset protection they offer, since they often possess the feature of short or non-existent statutes of limitations for recognizing foreign (*i.e.*, U.S.) judgments.

Although the IRS recognizes the *bona fides* of foreign asset protection trusts, it also seeks to tax such trusts. Because of the secrecy often associated with foreign trusts, the IRS may be unaware of the assets placed in a foreign trust. Foreign trusts are subject to strict reporting requirements by the IRS, with harsh penalties for failure to comply. Foreign asset protection trusts are not endowed with special tax attributes which by their nature legitimately reduce the incidence of U.S. income taxes.

Foreign trusts do accord a measure of privacy to the grantor, and may convey the impression that the creator of the trust is judgment-proof, even if that is not the case. A creditor seeking to enforce a judgment in a foreign jurisdiction would likely be required to retain foreign counsel, and litigate in a jurisdiction which might be generally hostile to his claim.

On balance, since asset protection trusts may now be created in several states within the U.S., resort to a foreign jurisdiction to implement such a trust would now seem to be an inferior method of accomplishing that objective.

## DEFERRED EXCHANGES, CONT.

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[W]e hold that it is still of like kind with ownership for tax purposes when the taxpayer prefers property to cash before and throughout the executory period, and only like kind property is ultimately received.

Responding to the IRS refusal to acquiesce to *Starker*, evolving case law which permitted nonsimultaneous exchanges was codified by the Tax Reform Act of 1984. As amended, Section 1031(a)(3)(A) provides that the taxpayer must

**IDENTIF[Y] . . . PROPERTY TO BE RECEIVED IN THE EXCHANGE [WITHIN] 45 DAYS AFTER . . . THE TAXPAYER TRANSFERS THE PROPERTY RELINQUISHED IN THE EXCHANGE.**

The Regulations refer to this as the “identification period.” Regs. § 1.1031(k)-1(b)(1)(i). The identification of the replacement property must be evidenced by a written document signed by the taxpayer and hand delivered, mailed, telecopied or otherwise sent before the end of the identification period to (i) the person obligated to transfer the replacement property to the taxpayer (*i.e.*, the qualified intermediary); or (ii) to all persons involved in the exchange (*e.g.*, any parties to the exchange, including an intermediary, an escrow agent, and a title company). Regs § 1.1031(k)-1(c)(2).

**The 45-day period is jurisdictional:** Failure to identify replacement property within 45 days will preclude exchange treatment. Moreover, contrary to many other time limitation periods provided for in the Internal Revenue Code, the 45-day period is computed without regard to weekends and holidays.

The statute states that the 45-day identification period begins upon the “transfer” of the relinquished property. Does the identification period therefore begin to run on the closing date? Or when the exchange funds are transferred if that date is not coin-

cident? Can an argument be made that the identification period does not commence until the deed is actually recorded?

Where multiple transfers of relinquished property occur, the 45-day identification period (as well as the 180-day exchange period) begin to run on the date of transfer of the first property. Treas. Reg. § 1.1031(k)-1(b)(2). The normal identification rules are applicable for multiple property exchanges

Some taxpayers, unable to identify replacement property within 45 days, have attempted to backdate identification documents. This is a serious mistake. The taxpayer in *Dobrich v. Com’r*, 188 F.3d 512 (9<sup>th</sup> Cir. 1999) was found liable for civil fraud penalties for backdating identification documents. *Dobrich* also pled guilty in a companion criminal case to providing false documents to the IRS. If the 45-day identification period poses a problem, the taxpayer should consider delaying the sale of the relinquished property to the cash buyer. If the sale cannot be delayed, the possibility should be explored of leasing the property to the cash buyer until suitable replacement property can be identified.

Section 1031 provides for non-recognition of losses as well as gains in deferred exchanges. This would appear to preclude the taxpayer from intentionally recognizing losses in some transactions in which loss property is disposed of. Although the IRS would likely be unhappy about the result, it would appear that a taxpayer could deliberately structure an exchange to recognize a loss by deliberately failing to identify replacement property within the 45-day identification period. This result appears correct since the failure to identify replacement property within 45 days appears to preclude the transaction from being within Section 1031.

## II. Identification of Replacement Property

Replacement property must be unambiguously described in a written document or agreement. Real property is generally unambiguously described by a street address or distinguishable name (*e.g.*, the Empire State Building). Personal property must contain a particular description of the property. For example, a truck generally is unambiguously described by a specific make, model and year. Regs. § 1.1031(k)-1(b)(1).

Acquisition of replacement property before the end of the identification period will be deemed to satisfy all applicable identification requirements (the “actual purchase rule”). Regs. § 1.1031(k)-1(c)(4)(ii)(A). However, even if closing is almost certain to occur within the 45-day identification period, formally identifying backup replacement property insures against not closing within the 45-day identification period and failing to meet the statutory requirements for an exchange.

**The identification of replacement property must satisfy one of the following four rules (which may not be combined in their application):**

1. Up to three replacement properties may be identified *without regard to fair market value*. Regs. § 1.1031(k)-1(c)(4)(i)(A).

2. Any number of properties may be identified provided their *aggregate fair market value does not exceed 200 percent of the aggregate fair market value* of all relinquished properties as of the date the relinquished properties were transferred. Regs. § 1.1031(k)-1(c)(4)(i)(B).

3. If more than the permitted number of replacement properties have been identified before the end of the identification period, the taxpayer will be treated as having identified no replacement property. However, a proper identification will be deemed to have been made with respect to (i) any

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replacement property received before the end of the identification period (whether or not identified); and (ii) any replacement property *identified* before the end of the identification period and *received* before the end of the exchange period, provided, the taxpayer receives before the end of the exchange period *identified* property the fair market value of which is at least 95 percent of the aggregate fair market value of all *identified* properties. Regs. § 1.1031(k)-1(b)(3)(ii)(A)-(B).

[Comment: In situations where the taxpayer is “trading up” and wishes to acquire replacement property whose fair market value is far in excess of the relinquished property, this rule is useful. While under the 200 percent rule the taxpayer may acquire property whose fair market value is twice that of the relinquished property, under the 95 percent rule, there is no upper limit to the new investment. While there is also no upper limit to the value of the replacement property using the 3 property rule, substantial diversification may not be possible using that rule.]

Although the 95 percent rule possesses distinct advantages, there is also a substantial risk: If the taxpayer does not satisfy the 95 percent rule, then the safe harbor is unavailable. This could result in the disastrous tax result of exchange treatment being lost with respect to all replacement properties. If the 95 percent rule is to be used, the taxpayer must be confident that he will ultimately be successful in closing on 95 percent of all identified properties. There is little room for error.]

4. In TAM 200602034, the taxpayer identified numerous properties whose fair market value exceeded 200 percent of the fair market value of the relinquished property. Thus, neither the “3-property rule” nor the “200 percent rule” could be satisfied. In addition, since the value of the replacement properties ultimately acquired was less than 95 percent of the value

of all identified replacement properties, the taxpayer failed the “95 percent” rule. Nevertheless, those properties which the taxpayer acquired within the 45 day identification period satisfied the “actual purchase rule”. Regs. § 1.1031(k)-1(c)(4)(ii)(A).

An identification may be revoked before the end of the identification period provided such revocation is contained in a written document signed by the taxpayer and delivered to the person to whom the identification was sent. An identification made in a written exchange agreement may be revoked only by an amendment to the agreement. Regs. § 1.1031(k)-1(c)(6). Oral revocations are invalid. Regs. § 1.1031(k)-1(c)(7), Example 7, (ii).

Regs. § 1.1031(k)-1(c)(5)(i) provides that minor items of personal property need not be separately *identified* in a deferred exchange. However, this exception in no way affects the important statutory mandate of Section 1031(a)(1) that only like kind property be *exchanged*. Therefore, if even a small amount of personal property is transferred or received, the like kind and like class rules apply to determine whether boot is present and if so, to what extent. It may therefore be advantageous for the parties to agree in the contract of sale that any personal property transferred in connection with the real property has negligible value. There also appears to be no reason why that parties could not execute a separate contract for the sale of personal property.

If multiple parcels are relinquished in the exchange, the 45-day period begins to run on the closing of the first relinquished property. The last replacement property must close within 180 days of that date. If compliance with this rule is problematic, it may be possible to fragment the exchange into multiple deferred exchanges.

If exchange proceeds remain, the determination of whether the taxpayer has made “multiple” or “alternative” identifications may be

important. If the identification was alternative, compliance with one of the three identification rules may be less difficult. Whether an identification is alternative depends on the taxpayer’s intent.

### III. Acquisition of Replacement Property Within “Exchange Period”

Section 1031(a)(3)(B) provides that replacement property must be acquired on the earlier of

**180 DAYS AFTER THE . . . TAXPAYER TRANSFERS THE PROPERTY RELINQUISHED IN THE EXCHANGE, OR THE DUE DATE [INCLUDING EXTENSIONS] FOR THE TRANSFEROR’S RETURN FOR THE TAXABLE YEAR IN WHICH THE TRANSFER OF THE RELINQUISHED PROPERTY OCCURS.**

Thus, if A relinquishes property on July 1<sup>st</sup>, 2011, he must identify replacement property by August 14<sup>th</sup>, 2011, and acquire all replacement property on or before January 1<sup>st</sup>, 2012, which date is the earlier of (i) January 1<sup>st</sup>, 2012 (180 days after transferring the relinquished property) and October 15<sup>th</sup>, 2012, (the due date of the taxpayer’s return, including extensions). This period is termed the “Exchange Period.” Regs. § 1.1031(k)-1(b)(1)(ii).

**The exchange period is also jurisdictional:** The taxpayer’s failure to acquire all replacement property within the exchange period will result in a taxable sale rather than a like kind exchange. The upshot of this rule is that (i) if the exchange occurs fewer than 180 days before the due date of the taxpayer’s return without extensions, an extension will be required to extend the exchange period to the full 180-days; and (ii) the exchange period will never be more than 180 days. *The exchange period, like the identification period, is calculated without regard to weekends and holidays.*

The Ninth Circuit, in *Christen-*

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*sen v. Com'r*, T.C. Memo 1996-254, *aff'd in unpub. opin.*, 142 F.3d 442 (9<sup>th</sup> Cir. 1998) held that the phrase "due date (determined with regard to extension)" in Section 1031(a)(3)(B)(i) contemplates an extension that is actually requested. Accordingly, if the taxpayer fails to request an extension (even if one were automatically available) the due date of the taxpayer's return without regard to extension would be the operative date for purposes of Section 1031(a)(3)(B).

(However, if the due date for the taxpayer's return without regard to extensions occurs after the 180-day period following the exchange (as in the example above), the point would be moot, since the exchange period can never exceed 180 days.

Replacement property eventually received must be substantially the same as the replacement property earlier identified. While the construction of a fence on previously identified property does not alter the "basic nature or character of real property," and is considered as the receipt of property that is substantially the same as that identified, the acquisition of a barn and the land on which the barn rests, without the acquisition also of the previously identified two acres of land adjoining the barn, will result in the taxpayer being considered not to have received substantially the same property that was previously identified. Regs. § 1.1031(k)-1(d), Examples 2 and 3.

Replacement property that is not in existence or that is being produced at the time the property is identified will be considered as properly identified provided the description contains as much detail concerning the construction of the improvements as is possible at the time the identification is made. Moreover, the replacement property to be produced will be considered substantially the same as identified property if variations due to usual or typical production occur. However, if substantial changes are made in the property to be produced, it will not

be considered substantially the same as the identified property. Regs. § 1.1031(k)-1(e).

#### IV. Actual or Constructive Receipt Negates Exchange

If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives the like kind replacement property, the transaction will constitute a sale and not a deferred exchange. If the taxpayer actually or constructively receives money or other property as part of the consideration for the relinquished property prior to receiving the like kind replacement property, the taxpayer will recognize gain with respect to the nonqualifying property received (to the extent of realized gain). Regs. § 1.1031(k)-1(f)(2).

For purposes of Section 1031, the determination of whether the taxpayer is in actual or constructive receipt of money or other property is made under general tax rules concerning actual and constructive receipt without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt when he actually receives money or other property or receives the economic benefit thereof.

Constructive receipt occurs when money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it. Section 446; Regs. § 1.446-1(c). However, the taxpayer is not in constructive receipt of money or other property if the taxpayer's control over its receipt is subject to substantial limitations. Regs. § 1.1031(k)-1(f)(1), (2). Thus, *Nixon v. Com'r*, T.C. Memo, 1987-318, held that the taxpayer was in constructive receipt of a check payable to taxpayer and not cashed, but later endorsed to a third party in exchange for (intended) replacement property.

#### V. Final Regulations

On April 25, 1991, final Regs for deferred exchanges were promulgated. Regs. § 1.1031(k)-1(g). Presumably, the vast majority of deferred exchanges (and all involving qualified intermediaries) must now comply with one of the four safe harbors in the regulations. Sensibly, the regulations also permit simultaneous exchanges to be structured under the qualified intermediary safe harbor. While simultaneous exchanges can also be structured outside of the safe harbors articulated in the deferred exchange regulations, compliance with the qualified intermediary safe harbor avoids issues of constructive receipt and agency. Note that the qualified intermediary safe harbor is the only deferred exchange safe harbor made applicable to simultaneous exchanges. Regs. § 1.1031(b)-2.

#### V(a). Security or Guarantee Arrangements

The first safe harbor insulates the taxpayer from being in actual or constructive receipt of exchange proceeds where the obligation of the cash buyer to provide funds for replacement property is secured by a mortgage or letter of credit. Specifically, the safe harbor provides that whether the taxpayer is in actual or constructive receipt of money or other property before receipt of replacement property will be made *without regard* to the fact that the obligation of the taxpayer's transferee (*i.e.*, the cash buyer) to transfer the replacement property to the taxpayer is or may be secured by (i) a mortgage; (ii) a standby letter of credit (provided the taxpayer may not draw on the letter of credit except upon default by the transferee); or (iii) a guarantee of a third party. Regs. § 1.1031(k)-1(g)(2). Compliance with this safe harbor eliminates concerns that the taxpayer is in constructive receipt of the secured obligations. *However, compliance with this safe harbor does not dispel concerns about agency.*

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### V(b). Qualified Escrow or Trust Accounts

The second safe harbor addresses situations in which exchange funds are segregated in an escrow or trust account. This safe harbor provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the receipt of replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property is or may be secured by cash or a cash equivalent, provided the funds are held in a "qualified escrow account" or a "qualified trust account." Regs. § 1.1031(k)-1(g)(3). *Note that compliance with this safe harbor also dispels concerns about constructive receipt, but also does not dispel concerns about agency. Only the qualified intermediary safe harbor, discussed below, addresses both of these issues.*

A qualified escrow (or trust) account is an escrow (or trust) account in which (i) the escrow holder (or trustee) is not the taxpayer or a "disqualified person," and (ii) the escrow agreement limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account before the end of the exchange period, or until the occurrence, after the identification period, of certain contingencies beyond the control of the taxpayer. Regs. § 1.1031(k)-1(g)(3)(iii).

The agent of the taxpayer is a disqualified person. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer. However, services rendered in furtherance of the like kind exchange itself, or routine financial, title

insurance, escrow or trust services are not taken into account.

A person who bears a relationship to the taxpayer described in Section 267(b) or Section 707(b), (determined by substituting in each section "10 percent" for "50 percent" each place it appears) is a disqualified person.

A person who bears a relationship to the taxpayer's agent described in either Section 267(b) or Section 707(b), (determined by substituting in each section "10 percent" for "50 percent" each place it appears) is also a disqualified person.

The regulations provide that a person will not be disqualified by reason of its performance of services in connection with the exchange or by reason of its providing "routine financial, title insurance, escrow or trust services for the taxpayer." Treas. Reg. § 1.1031(k)-1(k). The regulation permits banks and affiliated subsidiaries to act as qualified intermediaries even if the bank or bank affiliate is related to an investment banking or brokerage firm that provided investment services to the taxpayer within two years of the date of the exchange.

### V(c). Qualified Intermediaries

**The qualified intermediary (QI) safe harbor is the most useful of the four safe harbors, as it addresses both agency and constructive receipt concerns.** This safe harbor provides that (i) a "qualified intermediary" is **not considered an agent** of the taxpayer for tax purposes, and (ii) the taxpayer is **not considered to be in constructive receipt** of exchange funds held by the qualified intermediary. For the QI safe harbor to apply, the exchange agreement must expressly limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI, until after the exchange period, or until the occurrence, after the identification period, of certain contingencies beyond the control of the taxpayer. Regs. § 1.1031

(k)-1(g)(4).

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 its 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 to serve 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.

The QI safe harbor bestows upon the transaction the important presumption that the taxpayer is not in constructive receipt of funds held by the QI – regardless of whether the taxpayer would otherwise be in constructive receipt under general principles of tax law. In addition, the QI is not considered the taxpayer's agent for tax purposes. However, the QI may act as the taxpayer's agent for other legal purposes, and the exchange agreement may so provide. For example, if the taxpayer is concerned about the possible bankruptcy of the QI, expressly stating that the QI is the taxpayer's agent for legal purposes would reduce the taxpayer's exposure. So too, the QI may be concerned with taking legal title to property burdened with possible claims or environmental liabilities. By stating that the QI is acting merely as the taxpayer's agent, those concerns of the QI might be adequately addressed.

In a three-party exchange, the  
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cash buyer accommodates the taxpayer by acquiring the replacement property and then exchanging it for the property held by the taxpayer. Since the QI safe harbor imposes the requirement that the QI both acquire and transfer the relinquished property and the replacement property, it appears that this safe harbor cannot be used in a three-party exchange since, in such an exchange, the cash buyer acquires the taxpayer's property, but does not thereafter transfer it. Therefore, the qualified intermediary safe harbor would appear to always require four parties: *i.e.*, the taxpayer, the QI, a cash buyer and a cash seller.

The final Regulations permit the safe harbor for qualified intermediaries (but only that safe harbor) in simultaneous, as well as deferred, exchanges. Regs. § 1.1031(k)-1(g)(4)(v).

A qualified intermediary is a person who (i) is not the taxpayer or a "disqualified person" and who (ii) enters into a written agreement ("exchange agreement") with the taxpayer to (a) acquire the relinquished property from the taxpayer; (b) transfer the relinquished property to a cash buyer; (c) acquire replacement property from a cash seller; and (d) transfer replacement property to the taxpayer. Regs. § 1.1031(k)-1(g)(iii). A number of companies, often affiliated with banks, act as qualified intermediaries. If an affiliate of a bank is used as a QI, it may be prudent to require the parent to guarantee the QI's obligations under the exchange agreement. Qualified intermediaries generally charge a fee (*e.g.*, \$1,000), but earn most of their profit on exchange funds invested during the identification and exchange periods. Although the QI might pay the taxpayer one percent interest on exchange funds held during the identification and exchange periods, the QI might earn two percent during those periods, providing the QI with a profit of one percent on the exchange funds held during the identification and exchange periods.

A QI is treated as acquiring and transferring property (i) if the QI itself acquires and transfers legal title; or (ii) if the QI (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person; or (iii) if the QI (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. These rules permit the taxpayer to directly deed the relinquished property to the cash buyer, and also permit the owner of the replacement property to directly deed the replacement property to the taxpayer at the closing. Regs. § 1.1031(k)-1(g)(4)(iv)(A),(B)&(C). This may avoid additional complexity as well as additional transfer tax liability and recording fees.

A QI is treated as entering into an agreement if the rights of a party to the agreement are assigned to the QI and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant property transfer. Therefore, if a taxpayer enters into an agreement for the transfer of the relinquished property and thereafter assigns its rights thereunder to a QI and all parties to the agreement are notified in writing of the assignment on or before the date the relinquished property is transferred, the QI is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the QI is treated as having acquired and transferred the relinquished property. Regs. § 1.1031(k)-1(g)(v).

Regs. § 1.1031(k)-1(g)(3) permit the QI to deposit cash proceeds from the sale of the relinquished property into a separate trust or escrow account, which could protect funds against claims of the QI's creditors. The exchange documents must still

limit the exchanging party's right to receive, pledge, borrow or otherwise receive the benefits of the relinquished property sale proceeds prior to the expiration of the exchange period. Regs. § 1.1031(k)-1(g)(6). These are referred to as the "G-6 Limitations."

The obligation of the QI may be secured by a standby letter of credit or a third party guarantee. The standby letter of credit must be nonnegotiable and must provide for the payment of proceeds to the escrow to purchase the replacement property, rather than to the taxpayer.

Regs. § 1.1031(k)-1(g)(7) enumerates items which may be paid by the QI without impairing the QI safe harbor, and which will be disregarded in determining whether the taxpayer's right to receive money or other property has been expressly limited, as required. If an expense qualifies under the Regulations, not only will the QI safe harbor remain intact, but no boot will result.

Money or other property paid to the taxpayer by another party to the exchange will constitute boot, but will not destroy the safe harbor. Treas. Regs. § 1.1031(k)-1(g)(4)(vii). However, the payment to the taxpayer of money or other property from the QI or from another safe harbor arrangement prior to the receipt of all replacement properties to which the taxpayer is entitled under the exchange agreement will destroy the safe harbor. Regs. § 1.1031(k)-1(g)(6).

Regs. § 1.1031(k)-1(g)(7)(ii) provides that a QI may make disbursements for "[t]ransactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller (*e.g.*, commissions, prorated taxes, recording or transfer taxes, and title company fees)." Regs. § 1.1031(k)-1(g)(7)(i) provides that the QI may also pay to the seller items which a seller may receive "as a consequence of the dispo-

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sition of the property and that are not included in the amount realized from the disposition of the property (e.g., prorated rents)."

Payments made by a QI not enumerated in Regs. § 1.1031(k)-1(g) (7) would presumably constitute boot. However, the question arises whether those payments would also destroy the safe harbor. Regs. § 1.1031(k)-1(j)(3), Example 4, concludes the taxpayer who has a right to demand up to \$30,000 in cash is in constructive receipt of \$30,000, and recognizes gain to the extent of \$30,000. However, Example 4 neither states nor implies that the exchange no longer qualifies under the safe harbor. Therefore, payment of an expense not enumerated in Regs. § 1.1031(k)-1(g)(7) to a person other than the taxpayer would result in boot, but would likely not destroy the safe harbor. However, any payment from the QI to the taxpayer during the exchange period would destroy the safe harbor.

The ABA Tax Section Report on Open Issues first notes that Revenue Ruling 72-456, and GCM 34895 recognize that transactional expenses typically incurred in connection with an exchange, and not deducted elsewhere on the taxpayer's return, offset boot. The Report notes that these expenses correspond closely to the list of transactional items found in Regs. § 1.1031(k)-1(g)(7). The Report concludes that transactional selling expenses paid by a QI should be treated as transactional items under Regs. § 1.1031(k)-1(g)(7) which can be paid by the QI at any time during the exchange period without affecting any of the safe harbors under Regs. § 1.1031(k).

#### **V(c)(i). IRC §468B and Deemed Interest**

Prior to the enactment of Section 468B, most taxpayers were not reporting as income interest or growth attributable to exchange funds held in

escrow by qualified intermediaries, and later retained by the QI as a fee. Since the fee paid to the QI is an exchange expense that reduces the amount realized, the IRS believed that this amount was inappropriately escaping income taxation. Accordingly, on July 7, 2008, the IRS issued final Regulations under Section 468B(g) and 7872, which addressed the tax treatment of funds held by qualified intermediaries in various safe harbors provided by Treas. Reg. § 1.1031(k)-1(g). Under the final Regulations, exchange funds are, as a general rule, treated as loaned by the taxpayer to the QI, who takes into account all items of income, deduction and credit. The final Regulations apply to transfers of relinquished property made on or after October 8<sup>th</sup>, 2008. The QI must issue an information return (i.e., Form 1099) to the taxpayer reporting the amount of interest income which the taxpayer earned. Regs. § 1.468B-6(d).

The exchange agreement should provide for sufficient interest to be paid on funds held by the QI. Interest is sufficient if it at least equal to either the short-term AFR or the 13-week Treasury bill rate. If the exchange agreement fails to provide for sufficient interest, interest will be imputed under Section 7872.

Under Regs. § 1.468B, the taxpayer is treated as the owner of funds held by the QI in an escrow account. The taxpayer is then treated as loaning those funds to the QI. The QI is then treated as paying interest to the taxpayer on the exchange funds. The taxpayer will then be treated as compensating the QI with an amount equal to the deemed interest payment received. The rule forces the taxpayer to capitalize as part of the cost of acquiring property (rather than deduct as a current expense) amounts paid to the QI.

An exception to the rule provides that if exchange funds do not exceed \$2 million and the funds are held for six months or less, no interest will be imputed under Section 7872. Another exception provides that if the escrow agreement, trust agreement, or

exchange agreement provides that all earnings attributable to the exchange funds are payable to the taxpayer, the exchange funds are not treated as loaned by the taxpayer to the exchange facilitator. In that case, the taxpayer would take into account all items of income, deduction and credit. The "all the earnings" rule applies if (i) the QI holds all of the taxpayer's exchange funds in a separately identified account; (ii) the earnings credited to the taxpayer's exchange funds include all earnings on the separately identified account; and (iii) the credited earnings must be paid to the taxpayer (or be used to acquire replacement property).

The safe harbor deferred exchange regulations provide that the taxpayer will not be in constructive receipt of exchange funds for purposes of Section 1031. However, under the Proposed Regulations, an interesting tax dichotomy emerges: Even though the taxpayer is not considered as receiving the exchange funds for purposes of Section 1031, the taxpayer is treated as receiving those funds for other income tax purposes.

For purposes of determining whether earnings attributable to exchange funds are payable to the taxpayer, transactional expenses such as appraisals, title examinations, recording fees and transfer taxes are treated as first paid to the taxpayer and then paid by the taxpayer to the recipient. A fee paid to the QI qualifies as a transactional expense if (i) the amount of the fee is fixed on or before the date the relinquished property is transferred and (ii) the fee is payable regardless of whether earnings attributable to exchange funds are sufficient to cover the fee. This rule is intended to address the perceived problem of a qualified intermediary "fee" actually being used as an interest "surrogate."

#### **V(d). Interest and Growth Factors**

The fourth safe harbor provides that the determination of whether the taxpayer is in actual or constructive re-

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ceipt of money or other property before the receipt of replacement property is made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange funds. Regs. § 1.1031(k)-1(g)(5).

## VI. Requirements of the Exchange Agreement

The exchange agreement itself must expressly limit the taxpayer's right to pledge, borrow or otherwise obtain the benefits of the cash held in the escrow account before the end of the exchange period. Regs. § 1.1031(k)-1(g)(2)(ii). It is not enough that the limitations exist in an ancillary document, or that they derive from local law. In *Hillyer v. Com'r*, TC Memo 1996-214, the Tax Court denied exchange treatment and held a taxable sale occurred where the exchange agreement failed to contain restrictions on the taxpayer's right to constructive receipt of the proceeds pursuant to Regs. § 1.1031(k)-1(g)(6). *Florida Industries Investment Corp. v. Com'r*, 252 F.3d 440 (11<sup>th</sup> Cir. 2001) held that where the qualified intermediary was under the control of the taxpayer, the taxpayer had "effective control" of all escrow funds.

Regs. § 1.1031(k)-1(g)(6) provides several rules which permit the exchange agreement to modify the time when the taxpayer has access to exchange proceeds. If the taxpayer fails to identify any replacement property by the end of the identification period, the exchange agreement may provide that the taxpayer has access to exchange funds after the 45-day identification period. Regs. § 1.1031(k)-1(g)(6)(ii).

If the taxpayer receives all identified property prior to the end of the exchange period, the exchange agreement may provide that the taxpayer has access to exchange funds at that time. Regs. § 1.1031(k)-1(g)(6)(iii)(A). Therefore, if the taxpayer intends to close on one property, but identifies

multiple properties as potential "backup" properties, the taxpayer may have to wait until end of the 180-day exchange period to demand the balance of exchange proceeds held by the QI.

The exchange agreement may provide that if an unexpected contingency identified in the exchange agreement causes the exchange go to awry, the taxpayer may have access to exchange funds prior to the end of the exchange period. Thus, the taxpayer may retain the right to receive money held by the QI following the occurrence, after the identification period, of a material and substantial contingency that (i) relates to the deferred exchange; (ii) is provided for in writing; and (iii) is beyond the control of the taxpayer and any disqualified person. Regs. § 1.1031(k)-1(g)(6)(iii)(B).

PLR 200027028 held that exchange agreements could be modified to allow for early distribution of cash where taxpayer was unable to reach a contract with the seller of replacement property.

If the taxpayer has closed on all identified replacement property prior to the 46<sup>th</sup> day, then excess exchange proceeds may be distributed after that time, provided the exchange agreement so permits. If the taxpayer has identified no replacement property before the expiration of the 45-day identification period, then the exchange proceeds may be distributed on the 46<sup>th</sup> day, provided the exchange agreement so permits. The taxpayer may receive excess proceeds at the end of the exchange period, whether or not the taxpayer has closed on all properties identified in the identification period.

If the taxpayer has identified property during the identification period and that property has not been acquired by the end of the identification period, the exchange funds will be frozen with the QI until the 180-day exchange period has expired, or until the taxpayer acquires replacement property. This is true even if the taxpayer decides not to acquire identified replacement property on the 46<sup>th</sup> day. There-

fore, if the taxpayer has identified more than one property, and closes on only one property (either before or after the identification period), the remaining exchange proceeds will be frozen with the QI until after the exchange period has ended.

If the taxpayer has funds remaining in the exchange account following the identification period (if no identification is made) or at the end of the exchange period (if no or replacement property of lower value is acquired), the remaining exchange funds paid to the taxpayer over time may qualify for installment sale treatment. Special installment sale rules apply during the pendency of a like kind exchange pursuant to Treas. Regs. § 1.1031(k)-1(j)(2). Those rules protect the taxpayer from constructive receipt of the exchange funds during the exchange period. That "protection" terminates at the end of the exchange period.

As insurance against a failed exchange, at the time of the "(g)(6)" event, the QI may give an installment note to the taxpayer and assign the obligation under the note to an unrelated assignment company. The assignment company could use those funds to purchase an annuity from an insurance company to provide a funding source for the installment note. It is unclear whether this transaction would qualify for installment sale treatment. Structures like this are being marketed as a fallback to a failed exchange.

## VII. Installment Sale Reporting of Deferred Exchanges

To benefit from installment reporting, the taxpayer must avoid the receipt of "payment" in the taxable year of the disposition. Under the installment sale rules, a seller is deemed to receive payment when cash or cash equivalents are placed in escrow to secure payment of the sales price. Temp. Regs. § 15A.453-1(b)(3)(i). The regulations further provide that receipt of an evidence of indebtedness that is se-

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cured directly or indirectly by cash or a cash equivalent is treated as the receipt of payment. Accordingly, the IRS has suggested that the exchange funds described in the deferred exchange safe harbor Regulations could be considered as "payment" under Temp. Regs. § 15A.453-1(b)(3)(i).

Fortunately, the safe harbor deferred regulations, rather than Temp. Regs. § 15A.453-1(b)(3)(i), apply in determining whether the taxpayer is in receipt of "payment" at the beginning of the exchange period. Thus, Treas. Reg. § 1.1031(k)-1(j)(2) provides that a transferor is not deemed to have received an installment payment under a qualified escrow account or qualified trust arrangement, nor is the receipt of cash held in an escrow account by a qualified intermediary treated as a payment to the transferor under the rules, provided the following two conditions are met: (i) the taxpayer must have a "*bona fide* intent" to enter into a deferred exchange at the beginning of the exchange period and (ii) the relinquished property must not constitute "disqualified" property. See Temp. Reg. § 15A.453-1(b)(3)(i). Treas. Reg. § 1.1031(k)-1(k)(2)(iv) states that a taxpayer possesses a *bona fide* intent to engage in an exchange only if it is reasonable to believe at the beginning of the exchange period that like kind replacement property will be acquired before the end of the exchange period.

If the intent requirement is met, gain recognized from a deferred exchange structured under one or more of the safe harbors will qualify for installment method reporting (provided the other requirements of Sections 453 and 453A are met). However, the relief from the otherwise operative installment sale regulations ceases upon the earlier of (i) the end of the exchange period or (ii) the time when the taxpayer has an immediate right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or the cash equivalent. Treas. Reg. § 1.453-1(f)(1)(iii). At that time, the taxpayer

will be considered to be in receipt of "payment." However, if all gain is deferred because the taxpayer has completed a like kind exchange, no gain will be recognized.

To illustrate, assume that on December 1<sup>st</sup>, 2010, QI, pursuant to an exchange agreement with New York taxpayer (who has a *bona fide* intent to enter into a like kind exchange) transfers the Golden Gate Bridge to cash buyer for \$100 billion. The QI holds the \$100 billion in escrow, pending identification and ultimate closing on the replacement property by the taxpayer. The taxpayer's adjusted basis in the bridge is \$75 billion. The exchange agreement provides that taxpayer has no right to receive, pledge, borrow or otherwise obtain the benefits of the cash being held by QI until the earlier of the date the replacement property is delivered to the taxpayer or the end of the exchange period.

On January 1<sup>st</sup>, 2011, QI transfers replacement property, the Throgs Neck Bridge, worth \$50 billion, and \$50 billion in cash to the taxpayer. The taxpayer recognizes gain to the extent of \$25 billion. The taxpayer is treated as having received payment on January 1<sup>st</sup>, 2011, rather than on December 1<sup>st</sup>, 2010. If the other requirements of Sections 453 and 453A are satisfied, the taxpayer may report the gain under the installment method.

If the QI failed to identify replacement property by January 15<sup>th</sup>, 2011 (the end of the identification period) and distributed \$50 billion in cash to taxpayer, under Regs. § 1.1031(k)-1(j)(2)(iv) the taxpayer could still report gain using the installment method, since the taxpayer had a *bona fide* intent at the beginning of the exchange period to effectuate a like kind exchange. (The same logic would apply if the taxpayer had identified replacement property but had failed to close on the replacement property by May 30<sup>th</sup>, 2011, the end of the exchange period.)

Under its "clawback" rule, California will continue to track the deferred gain on the exchange involving

the Golden Gate Bridge. If the taxpayer later disposes of Throgs Neck Bridge in a taxable sale, California will impose tax on the initial deferred exchange. This will result in the taxpayer paying both New York (8.97 percent) and California (9.3 percent) income tax, in addition to New York City (4.45 percent) and federal income tax (15 - 25 percent) on the later sale.

In PLR 200813019, the IRS permitted the taxpayer to correct an inadvertent opt-out of the installment method. The taxpayer had intended to engage in a like kind exchange, but failed to acquire replacement property within 180 days. The taxpayer's accountant reported had all of the income in year one, even though the failed exchange qualified as an installment sale because the taxpayer had not been in actual or constructive receipt of some of the exchange proceeds until the year following that in which the relinquished property was sold. Treas. Reg. § 15.453-1(d)(4) provides that an election to opt-out of installment sale treatment is generally irrevocable, and that an election may be revoked only with the consent of the IRS. The IRS allowed the taxpayer to revoke the inadvertent opt-out, noting that the opt-out was the result of the accountant's oversight, rather than hindsight by the taxpayer.

#### VIII. Installment Method of Reporting Boot Gain

Section 453 provides that an "installment sale" is a disposition of property where at least one payment is to be received in the taxable year following the year of disposition. Income from an installment sale is taken into account under the "installment method." The installment method is defined as a method in which income recognized in any taxable year following a disposition equals that percentage of the payments received which the gross profit bears to the total contract price. Consequently, if a taxpayer sells real estate with a basis of \$500,000 for \$1

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million, 50 percent of payments (*i.e.*, gross profit/total contract price) received would be taxable as gross income. Gain recognized in a like kind exchange may be eligible for installment treatment if the taxpayer otherwise qualifies to use the installment method to report gain.

Section 453(f)(6)(C) provides that for purposes of the installment method, the receipt of qualifying like kind property will not be considered "payment." However, the Temporary Regulations provide that the term "payment" includes amounts actually or constructively received under an installment obligation. Therefore, the receipt of an installment obligation in a like kind exchange would constitute boot. Prop. Reg. § 1.453-1(f)(1)(iii) provides for the timing of gain upon receipt of an installment obligation received in a like kind exchange. Installment notes (which qualify for installment reporting) received in a like kind exchange would not be taxed as the time of the exchange. Rather, as payments are received on the installment obligation, a portion of each payment would be taxed as gain, and a portion would constitute a recovery of basis.

The Regulations generally allocate basis in the transferred property entirely to like kind property received in the exchange where an installment obligation is received. The result is that less basis is allocated to the installment obligation. This is disadvantageous from a tax standpoint, since a greater portion of each payment received under the installment obligation will be subject to current tax.

To illustrate, assume taxpayer exchanges property with a basis of \$500,000 and a fair market value of \$1 million for like kind exchange property worth \$750,000 and an installment obligation of \$250,000. The installment note would constitute boot, but would be eligible for reporting under the installment method. Under the Proposed Regulations, the entire \$500,000 basis would be allocated to the like kind replacement property received in

the exchange. No basis would be allocated to the installment obligation. Consequently, 100 percent of all principal payments made under the note would be taxed as gain to the taxpayer. Had the \$500,000 basis instead been permitted to be allocated to the installment obligation and the replacement property in proportion to their fair market values, the note would have attracted a basis of \$125,000 (*i.e.*,  $1/4 \times \$500,000$ ). In that case, 50 percent ( $\$125,000/\$250,000$ ) of each payment would have been a return of basis, and only 50 percent would have been subject to tax. The remainder of the realized gain would have been deferred until the replacement property was later sold.

#### IX. Treatment of Earnest Money Deposits

Any deposit held by the taxpayer's attorney should be assigned (along with all of the taxpayer's rights in the relinquished property contract) to the QI. The taxpayer's attorney could also (i) refund the deposit to the purchaser prior to closing, and request that the purchaser cut a check directly to the QI; (ii) refund the deposit to the purchaser at closing, and increase the purchase price to reflect the refund; or (iii) or release the deposit to the QI at closing.

If the taxpayer contemplates pursuing a like kind exchange, no deposit should be paid to the taxpayer directly. However, if this is a *fait accompli*, the taxpayer should remit the funds as soon as possible to the QI or, if no QI has been engaged, to the taxpayer's attorney. If no deposit has been made before the purchase contract has been assigned to the QI, the deposit should be paid directly to the QI.

If the taxpayer is in contract for the purchase of the replacement property before the QI is engaged, the taxpayer will have made the deposit with his own funds. It would clearly violate the deferred exchange "G-6" limita-

tions if the QI reimburses the taxpayer for the deposit prior to closing from exchange funds. However, the QI could reimburse the taxpayer from the exchange funds at closing. The seller could also refund the deposit to the taxpayer at closing, with the QI providing a replacement check.

The QI may make a deposit for replacement property only after the purchase agreement for the replacement property has been assigned the QI. The escrow instructions should provide that if the taxpayer does not close on the property, or if the contract is terminated for any reason, the deposit will be returned to the QI and not the taxpayer.

#### X. Failed Exchanges

Consolidation of qualified intermediaries has raised concerns regarding transfers of QI accounts during exchanges. There continues to be concern with respect to QI insolvencies in the wake of several well-publicized failures. In *Nation-Wide Exchange Services*, 291 B.R. 131, 91 A.F.T.R.2d (March 31, 2003), the qualified intermediary commingled exchange funds in a brokerage account and sustained significant losses. The Bankruptcy Court found that the failure of Nation-Wide to use segregated accounts effectively converted customer deposits to property of Nation-Wide for purposes of bankruptcy law. All disbursements made by Nation-Wide in the 90 days preceding its bankruptcy were returned to the bankruptcy trustee.

More recently, LandAmerica 1031 Exchange Services Company, Inc., a qualified intermediary, invested exchange funds in auction rate securities that became illiquid in 2008. LandAmerica was unable to sell or borrow against those securities, and was forced to seek bankruptcy protection. Since the exchange proceeds were frozen, clients in the midst of an exchange were unable to complete their exchanges within the exchange period. Consequently, those taxpayers' con-

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**DEFERRED EXCHANGES, CONT.**

*(Continued from page 42)*

templated exchanges turned into taxable sales. Since the exchange proceeds were frozen in bankruptcy proceedings, the taxpayers were deprived of the sale proceeds with which to satisfy those tax liabilities. Fortunately, the IRS provided relief in Rev. Proc. 2010-14.

Rev. Proc. 2010-14 provides guidance concerning a failed exchange caused by the collapse or bankruptcy of a QI. 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.”

The Federation of Exchange Accommodators (FEA) have requested the Federal Trade Commission (FTC) and the IRS to regulate qualified intermediaries. Both have declined. A few states, including Nevada and California, do regulate qualified intermediaries. Under California law, the QI is required to use a qualified escrow or trust, or maintain a fidelity bond or post securities, cash, or a letter of credit in the amount of \$1 million. The QI must also have an errors and omissions insurance policy. Exchange facilitators must meet the prudent investor standard, and cannot commingle exchange funds. A violation of the California law creates a civil cause of action.