TAX NEWS & COMMENT

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IRS MATTERS

IRS Ruling Provides Basis for Asset Protection Trust in Nevada

NY Income Tax Planning

I. Tax & Asset Protection Benefits of PLR 20130002

PLR 201310002 blessed a theorized tax planning and asset protection strategy that fuses elements of grantor trusts, asset protection and trust taxation in a manner that accomplishes many salient tax and asset protection objectives. The objectives are achieved by forming a grantor trust in a state with no income tax that also recognizes the ability of a grantor to establish and fund a self-settled spendthrift trust.

New York imposes among the highest level of income tax of all

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FROM THE COURTS

Analysis of Recent Fiduciary Decisions in Surrogates Court

I. Constructive Trusts & Powers of Attorney

A "constructive trust" arises when equity intervenes to 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 unjustly enriched. In New York, four conditions must exist before a constructive trust is imposed: (i) a fiduciary or confidential relationship; (ii) a promise; (iii) a transfer in reliance on the promise; and (iv) unjust enrichment.

In a recent case, the Surrogate

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FROM WASHINGTON

2012 TREASURY REPORT ON SOCIAL SECURITY & MEDICARE

Elder Law

I. Introduction

Treasury's 2012 Report to Congress on the financial health of Social Security and Medicare emphasized that Americans are living longer and that the number of retirees is growing. This is placing pressure on Social Security, which is projected to have sufficient funds until 2033, and also on Medicare's Hospital Insurance Trust, which is expected to have sufficient resources until 2024.

The projections are more pessimistic than those of the previous

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Elements of New York Criminal Tax Fraud

Criminal Tax Law

I. Introduction

Preparers of New York State corporate, income, employment and sales tax returns should be aware of strict criminal penalties that await their clients, and should also be aware that in extreme cases, tax professionals themselves could theoretically be prosecuted under an accomplice theory for aiding or abetting dishonest taxpayers.

Tax legislation enacted in 2009 focused on tax evasion and tax fraud. Serious acts of tax evasion now

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Executor and Trustee Commissions

I. Executor Commissions

Executors and Trustees are entitled to compensation for serving in their fiduciary capacity. The will or trust may provide a fee schedule or may provide for a waiver of fiduciary fees. If the will is silent or provides for statutory commission, then reference should be made to the Section 2307 of the Surrogates Court and Procedure Act (SCPA).

SCPA §2307 provides that an executor is entitled to a commission rate of 5 percent on the first $100,000 in the estate, 4 percent on the next

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MAY COMMENT

Tax Planning for Divorce

Federal Income Tax Planning

I. Introduction

In an action for divorce, property is subject to "equitable distribution" pursuant to Domestic Relations Law (DRL) §236. New York distinguishes between "marital" property, which is subject to equitable distribution, and "separate" property, which is not. The distinction is crucial, because the Court of Appeals has held that marital property includes items that under the common law would be considered the separate property of one

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year, since there was an increase in the "actuarial imbalance" of 0.6 percent due to changes in cost projection methods. The Report noted that a major reform that will place these programs on a "sounder national footing" is the full implementation of the Affordable Care Act.

The Report noted that President Obama is committed to strengthen Medicare by "reigning in" health care costs. This may be accomplished by (i) eliminating "excessive subsidies" to drug companies; (ii) creating "new incentives" for doctors and hospitals, and (iii) "asking" the wealthiest seniors to pay more.

The Report also noted that President Obama is committed to keeping Social Security strong for future generations, recognizing that more private employers are "mov[ing] away" from defined benefit plans. The "solution" for Social Security involves "finding a bipartisan solution that does not hurt current recipients, slash benefits for future generations, or tie the program to the stock market."

The Report found that long-term Medicare costs increased by reason of cost growth rate assumptions. Similarly, the actuarial deficit in Social Security increased due to updated economic data and assumptions. Since both programs cannot maintain projected long-term costs under current financing, the Report emphasized the importance of Congress acting "sooner rather than later" to phase in changes so that the public "has adequate time to prepare."

Noting that Social Security and Medicare account for 36 percent of all federal expenditures, the Report also predicted that the influx of baby-boomers into the programs will, through the 2030's, result in program costs exceeding GDP. Thereafter, increased longevity and increased health care costs would cause program costs to increase only "somewhat more rapidly" than GDP.

II. Social Security

Social Security expenditures exceeded non-interest income in 2010 and 2011 for the first time since 1983, and the imbalance is expected to continue over the 75-year projection period. Redemption of trust fund assets from the General Fund of the Treasury is expected to offset such annual cash-flow deficits

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in the near term. Since the redemptions will be less than the interest earnings through 2020, nominal trust fund balances should continue to grow.

The trust fund ratio, an indicia of the number of years the program could be funded with current trust fund reserves, peaked in 2008, declined in 2011, and is expected to decline in future years. After 2020, Treasury will redeem trust fund assets in amounts that exceed interest earnings until exhaustion of trust fund reserves in 2033. Thereafter, tax income would be sufficient to pay only three-fourths of scheduled benefits through 2086.

The temporary reduction in the Social Security payroll tax rate reduced payroll tax revenues by $215 billion in 2011 and 2012. However, that reduction was offset by providing for transfers from the general fund to trust funds.

Under current projections, the annual cost of Social Security benefits expressed as a percentage of worker's taxable income will grow rapidly from 11.3 percent in 2007 to about 17.4 percent in 2035, and then decline slightly after 2050.

The projected 75-year actuarial deficit for the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds was 2.67 percent of taxable payroll, up from 2.22 percent in 2011. This is the largest actuarial deficit reported since prior to 1983, and the largest single-year deterioration in the actuarial deficit since 1994. While the combined OASDI program continues to fail the long-range test of actuarial balance, the combined trust fund assets will exceed one year's projected cost through 2027.

However, the Disability Insurance program fails both the actuarial deficit test and the long-range test for financial solvency: The Report concluded that without Congressional action, trust fund exhaustion will occur in 2016, two years earlier than previously projected.

III. Medicare

The Medicare Hospital Insurance (HI) Trust Fund faces depletion earlier than the Social Security Trust fund, although not as soon as the Disability Trust Fund. The long-term actuarial imbalance of HI Medicare is less than that of Social Security.

Medicare costs are projected to grow from the rate of 3.7 percent of GDP to 5.7 percent of GDP by 2035, and to 6.7 percent of GDP by 2086. The projected 75-year actuarial imbalance of the HI Trust Fund is 1.35 percent of taxable payroll, up from 0.79 percent in the 2011 Report. The HI Trust Fund fails the test of short-term solvency, since projected costs are less than projected expenditures, and are expected to continue declining.

Viewed in long-term perspective, the HI Trust Fund is projected to pay out more in hospital benefits and other expenditures than it receives in income, as it has since 2008. The projected date of HI Trust Fund Exhaustion is 2024, the same date as in the 2012 Report. Once the HI Trust Fund is exhausted, dedicated revenues would be sufficient to pay 87 percent of HI Trust Fund costs.

The Report concluded that the worsening in long-term HI finances is principally due to the adoption of changes in assumptions recommended by the 2010-11 Medicare Technical Review Panel, which increases the projected long-range annual growth rate of Medicare costs by 0.3 percent.

The Report projected that Part B of Supplemental Medical Insurance (SMI), which funds doctors' bills and other outpatient expenses, as well as Part D, which provides funds for prescription drug coverage, will remain adequately financed into the future because current law has a built-in feature that provides financing for the following year's expenses. Nevertheless, the Report noted that the aging population and rising health care costs will result in the projected costs of SMI to grow from 2.0 percent of GDP in 2011 to approximately 3.4 percent of GDP in 2035, and then more slowly to 4.0 percent of GDP by 2086. General revenues are expected to finance about three-quarters of this cost. Premiums paid by beneficiaries are expected to cover the remaining quarter of the cost. SMI also receives some financing from the States and from drug manufacturers.

IV. Impact of the Affordable Care Act

The Report found that Medicare costs projected over 75 years are substantially lower than they would otherwise be because of the Affordable Care Act. Most of the annual 1.1 percent in cost-savings is attributable to a reduction in annual payments for most Medicare services (other than physicians' services and drugs).

The Report cautions that maintaining the annual percentage reduction in Medicare costs will be contingent on the permanent adoption of "efficiency-enhancing innovations in health care delivery systems." The Report also assumes that a planned 31 percent reduction in Medicare payment rates for physician services, required under the law, but which is "highly uncertain," will actually occur.

V. Conclusion

The Treasury Report concluded that the decline in Social Security and Medicare HI Trust Fund will place "mounting pressure" on the Federal budget. For the sixth consecutive year, the Trustees, pursuant to the Social Security Act, issued a "Medicare funding warning," since projected non-dedicated sources of revenues, principally general revenues, are expected to exceed 45 percent of total Medicare outlays. This threshold was first breached in 2010. Treasury implored Congress to address the problems facing Social Security and Medicare as soon as possible, in order to provide more options and provide the public with adequate time to prepare for the changes.

President Obama, together with Congress, corrected the decades-long

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failure of Washington to provide the assurance of health care to all Americans. The Affordable Care Act now compliments Social Security and Medicare. Together, these programs have the potential to fulfill the promise made by the federal government to working Americans that their contribution to Social Security and Medicare will ensure that they receive the resources necessary to enable them to remain healthy and productive in their retirement years.

For this promise to be kept, the work of President Obama and of Congress must continue. Washington must succeed in its efforts to ensure that Social Security and Medicare remain viable. One measure of the viability of these programs are the projected dates at which the programs will become insolvent. Of late, those dates have become alarmingly close.

FROM THE COURTS, CONT.

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held that in certain circumstances, a constructive trust can be established even after the death of the Settlor. Thus, in *Matter of Chantarasmi*, 2012 N.Y. Misc. Lexis 302 (2012), the court granted a petition requesting the creation of a constructive trust in a situation where the decedent died intestate, and there had been clear language in a prenuptial agreement requiring the decedent to create a trust for the benefit of his children.

The court reasoned that the decedent's failure to leave a will constituted a breach of the premarital agreement that could be remedied only by the creation of a constructive trust. The prenuptial agreement clearly contemplated the existence of the trust, and designated the intended beneficiaries, the trustees, and the subject property of the proposed trusts.

In *Peroise v. LiGreci*, 2012 WL 2819300 (2nd Dept. 2012), the court addressed the issue of whether personal involvement of the settlor is required for trust terms to be amended. In that case, fifteen days before the settlor's death, his daughter executed an amendment to an irrevocable trust replacing the trustee and successor trustee. The daughter was acting under a power of attorney, and the trust was for the benefit of the daughter and her siblings.

The trustee who was replaced objected. The court vacated the trust amendment reasoning that the trust was irrevocable and could only be amended by complying with the statutory requirement of obtaining the consent of all persons with a beneficial interest in the trust.

The Second Department reversed, stating that "absent any special circumstances or contrary directives, the amendment of the Trust by the attorney-in-fact, with the consent of all the beneficiaries, was not an act which 'by [its] nature, by public policy, or by contract,' required the creator's personal performance." The court further held that unless a trust by its very terms prohibits the creator from amending by way of his attorney-in-fact, the attorney in fact, as the alter ego of the creator, may amend the trust.

II. Prudent Investor Standard

Matter of Korn, 36 Misc.3d 1224A (Sur. Ct. 2012) involved an objection to an accounting by a trust beneficiary, the brother of the trustee, who was also a trust beneficiary. The alleged breach of fiduciary duty related to whether the trustee had failed to act prudently in not exercising a right of first refusal to acquire certain real estate.

The Surrogate held that the prudent person standard of investing governed the trustee, and required that the trustee employ prudence in the care of trust assets equivalent to that of a prudent person of discretion and intelligence in managing his or her own affairs. Applying that standard, the Surrogate found that the trustee had invested prudently in that the trust had insufficient liquid assets available to purchase the real estate, and also was already heavily invested in real estate.

EPTL 11-2.3[b]-2.3 (the NY Prudent Investor Act) provides that a trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes, terms and provisions of the governing instrument.

In *Matter of Knox*, 2012 N.Y. App. Div, LEXIS 4880 (4th Dept. 2012), trust beneficiaries objected to a trust accounting alleging a failure to properly diversify stock investments. The beneficiaries alleged that the trustee had breached his fiduciary duty by imprudently retaining a high concentration of stock in two companies. The beneficiaries further alleged that the trustee had improperly relied upon the advice of a family member who was not a trustee. The Surrogate held that the trustee had negligently managed the trust by failing to maintain proper documentation and failing to develop an investment plan.

The Appellate Division reversed primarily on the ground that the trust instrument itself expressly granted the trustee the power to invest without regard to diversification. The Court also noted that even though assets were held in "overweight" positions, the objectant had failed to demonstrate that it was imprudent to do so, and the objectant had failed to show a financial loss from the holdings.

In contrast, in *Matter of Hunter*, 2010 NY Slip Op 50548U, the Surrogate of Westchester County imposed a surcharge of $4.322 million against JP Morgan Chase, a trustee that had failed to diversify a stock portfolio which consisted entirely of Eastman Kodak stock. The Surrogate held that a prudent trustee would have sold 95 percent of the Kodak stock, noting that JP Morgan Chase had no written investment plan for the trust, other than to eventually sell some of the Kodak Stock. The Surrogate imposed a surcharge based upon the lost capital to the trust.

On appeal, the Second Department found "no reason" to disturb the Surrogate's finding that JP Morgan Chase had violated both the prudent-person standard of investing and the Prudent Investor Act, noting that the high concentration of Kodak stock had been held for twenty years. The Appellate Division also remarked that JP Morgan Chase had "acted contrary to its own internal policies, which restrict the retention of any one stock unless certain circumstances existed, none of which were present. *Matter of Hunter*, NY Slip Op 08124, 11/28/12.

III. Delays in Distribution

When a trust terminates, trustees who delay in distributing assets to the beneficiaries do so at their own peril. In *Matter of McCluskey*, 951 N.Y.S.2d 852 (Nassau Cty Surr. 2012), the trustee failed to distribute trust assets for over a year after the trust terminated, by which time trust assets had declined in value. The trustee argued that damages should be mitigated if (i) the beneficiaries would

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have made the same mistake as the trustee or if (ii) the value of the trust assets appreciated subsequent to the distribution such that any theoretical loss was negated. Finding the arguments without merit, the Surrogate denied the motion made by the Trustee to compel production of the beneficiaries' personal investment portfolios for the period during which it was alleged that the Trustee had been neglectful in distributing trust assets.

Matter of Lasdone, 2011 NY Slip Op 51710U (NY Cty Surr. Court, 2011) also presented a situation where the trustee had delayed distribution of trust assets, during which time the value of trust assets declined. The trustee had refused to timely distribute trust assets to two beneficiaries who had been entitled to receive trust assets upon attainment of age thirty-five. The Surrogate granted summary judgment to the beneficiaries on their surcharge claim.

With respect to the issue of damages, the Surrogate ruled that the surcharge award should not be reduced by the capital gains tax that would have been incurred by the beneficiaries, since the beneficiaries could have held the stock until their respective deaths, thus benefitting from a stepped up basis. The Surrogate held that reasonable attorneys' fees should be chargeable to the estate, and not to the trustee, since the cost of preparing the accountings and other work done by the attorneys was necessary to the administration of the estate.

IV. Importance of Trust Definitions

In re: the Trust created by Lydia Butler Dwight, 2012 NY Slip Op 22229, dealt with a trust created for the benefit of the Settlor's "lawful issue." The question was whether the term "lawful issue" includes a premarital child. The Surrogate held that a premarital child was not a beneficiary of the trust because under the law as it existed when the trust was created, the term "lawful issue" included only children born in wedlock.

V. Jurisdiction and Standing

In *Cohen v. Cohen*, 2012 N.Y. Misc. LEXIS 25 (Jan. 5, 2012), the president of a for-profit university created a trust to hold real property on which the university was located for the benefit of his children and a family limited partnership used to transfer shares in the university to his children as part of an estate plan.

There were lease and loan agreements between the trust, college, family limited partnership, and the children. One of the children brought an action against the father, the college, and its board of trustees, alleging breach of fiduciary duties.

The college and its board of trustees intervened in the action and moved for summary judgment dismissing the complaint on the ground that the family limited partnership and the trust was formed in violation of tax law, and that enforcement of the partnership agreement and trust agreement would thereby result in judicial enforcement of an illegal contract.

The children challenged the college's intervention, arguing that the college lacked standing to challenge the enforceability of the partnership and trust agreements. The court held that the issue of standing was not relevant to the proceeding because New York case law permits a court to allow a motion based on illegality that invokes principles of public policy, regardless of the movant's standing.

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states. New York City residents pay even more tax for the privilege of residing there. Income is taxed to the grantor of a grantor trust. Since income is taxed to the grantor of a grantor trust, it is axiomatic that a New York resident who creates a grantor trust with its situs in New York will be taxed at a high rate on trust income. New York also does not recognize the right of a person to create a self-settled spendthrift trust that will be beyond the reach of the settlor's creditors.

II. Assumptions

¶ Assume New York resident owns assets with unrealized capital gain or assets which produce a high stream of annual income. If the assets are sold, or when the income is received, New York will take a large tax bite out of the sale or the annual income stream.

¶ Assume further that even if the trust is a New York "resident" trust, and therefore potentially subject to New York tax, that New York will not tax the trust because it meets the exception provided in Tax Law §605 (b)(3)(D)(i): (i) All of the trustees are domiciled in another state; (ii) the entire trust corpus is located outside of New York and (iii) all income and gains are derived from out of state sources. Therefore, the New York resident trust (*i.e.*, an *inter vivos* trust created by a New York resident) escapes taxation because it meets the exception in the exception in Tax Law §605(b) (3)(D)(i),

¶ Finally, assume that asset protection is an important objective of the settlor, since unknown future creditors may appear down the road and may be attracted to the scent of the grantor's assets. How can taxes be reduced? How can gift tax be avoided? Finally, how can the assets be protected against claims of future unknown creditors?

III. Avoid Grantor Trust Status & Protect The Trust Assets

First, how can grantor trust status be avoided so that trust income does not flow through to the New York resident and be taxed by New York? Treas. Reg. §1.677(a)-1(d), the first impediment, states that a trust is a grantor trust if the grantor's creditors can reach trust assets under applicable state law. However, a few states, among them Nevada, Delaware, and Alaska now recognize the right of a settlor to create a self-settled spendthrift trust. If the trust were established as an irrevocable non-grantor trust in Nevada, a state that also imposes no income tax, New York would have no claim to tax the trust, provided the exception to resident trust taxation was met.

It should be noted, if not emphasized, that not all states employ the criteria utilized by New York in defining and taxing resident state trusts. Unlike New York, some states do not impose income tax based upon the residence of the grantor. In those states, the benefit of PLR 2013110002 would be more easily achieved. In New York, the New York resident trust would have to fall within the exception in Tax Law §605(b)(3)(D)(i). Nevertheless, for New York residents able to meet the exemption in Tax Law §605(b)(3)(D)(i), the ruling may be of considerable value. *See* "Income Tax Planning for New York Trusts," *Tax News & Comment, October 2012*.]

IV. Facts in PLR 201310002

The facts in PLR 201310002 involve a situation where the grantor creates an irrevocable trust in which the grantor and his issue are discretionary beneficiaries. The trust provides that a corporate trustee distributes income and principal to the discretionary beneficiaries, consisting of the grantor and his issue.

For reason stated above, settling the trust in Nevada will avoid the application of Treas. Reg. §1.677(a)-1 (d), and the trust will not *automatically* be a grantor trust, since self-settled spendthrift trusts are valid in Nevada. However, another vexing problem in avoiding the application of the grantor trust rules lies in IRC §674, which provides that the Grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment is controlled by the Grantor or a "nonadverse" party.

The facts in PLR 201310002 present a situation where the consent of an adverse party is required with respect to all distributions made during the grantor's lifetime. IRC §672(a) provides that for the purpose of the grantor trust rules, the term "adverse party" means any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

If by now one is getting a sense of *déjà vu*, then that sense is correct. The situation involved in PLR 201310002 is the inverse of the familiar sale of assets to grantor trusts, which is a staple in estate planning. In sales to grantor trusts there is a complete transfer for transfer (gift, estate and GST) tax purposes, but an incomplete transfer for income tax purposes. Sales of assets to grantor trusts are generally made for estate tax purposes, as the asset is sold to the trust in exchange for an asset expected to appreciate less rapidly. The sale evades the capital gains tax because under Revenue Ruling 85-14, the sale by the grantor to a grantor trust has no income tax consequences.

In sharp contrast to sales to grantor trusts, transfers to the trusts contemplated in PLR 201310002 result in a complete transfer for income tax purposes, but an incomplete transfer for transfer tax purposes. Such trusts are referred to by tax and estate lawyers as "DING" trusts, or a "Delaware Incomplete Gift Non Grantor Trust," or "NING" trusts, with Nevada substituted for Delaware.

The grantor trust provisions in IRC Sections 671 through 679 cast a

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wide net. How exactly does PLR 201310002 suggest the resolution of the problem of the self-spendthrift trust avoid being taxed as grantor trust for other reasons? Very carefully and very methodically. The facts in PLR 201310002 provide that a corporate trustee is required (i) to distribute income or principal at the **direction** of a "distribution committee" or (ii) to distribute principal at the **direction** of the grantor.

In the facts of the ruling, the distribution committee consists of the grantor and his four children. At least two "eligible individuals" must at any time be serving as members of the distribution committee. The direction made by the distribution committee to the corporate trustee may be made in three ways:

Grantor-Consent Power:

> Distribute income or principal upon direction of a majority of the distribution committee with the written consent of the Grantor. Note: The PLR expressly concludes that distributions pursuant to the Grantor-Consent Power can be made only with the consent of an adverse party, and thus the provision does not cause the trust to be a grantor trust. Thus, the PLR implicitly concludes that the distribution committee members are adverse to the grantor for purposes of the grantor trust rules.

Unanimous Member Power:

> Distribute income or principal upon direction by all distribution committee members other than the Grantor. Note: the PLR expressly concludes that distributions pursuant to the Unanimous Member Power can be made only with the consent of an adverse party, and thus the provision does not cause the trust to be a grantor trust. Thus, the PLR implicitly concludes that the distribution committee members are adverse to the grantor for purposes of the grantor trust rules.

Grantor's Sole Power:

> Distribute principal to any of grantor's issue (not to grantor, and not income) upon direction from grantor as grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of the issue. Distributions can be directed in an unequal manner among potential beneficiaries. Note: Here, it would seem at first blush that the grantor has retained some power that might cause grantor trust problems. However, that bullet is dodged, as IRC §674 (b)(5)(A) provides an exception to grantor trust status for a grantor who has retained the power to distribute corpus (*i.e.*, principal) that is limited by a reasonably definite standard.

IV. Avoiding The Gift Tax

The DING or NING trust must also be structured to avoid gift tax, since the gift tax rate is now 40 percent once the lifetime exemption of $5 million is breached. The trust also needs to be irrevocable. Making an irrevocable trust incomplete for gift tax purposes is difficult, though possible. PLR 201310002 sanctions the use of a testamentary limited power of appointment to make the gift incomplete.

There is some concern that Chief Counsel Advisory 201208026 takes the position that the grantor's retention of a testamentary power of appointment over a trust renders the remainder interest a completed gift, but not the term interest. If this is indeed the case, then the grantor would need to retain other powers in order to make the gift incomplete.

However, the retention of other powers could cause the ship to list, and fall back into the gravitational pull of the grantor trust provisions, defeating the *raison d'etre* for the trust. For now, the planning tool of using DING or NING trusts to avoid state income taxation and to protect assets seems viable, if for no reason other than the fact that PLR 201310002 approved of the technique and without discussing the possible application of CCA 201208026.

NY CRIMINAL TAX STATUTES, CONT.

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attract far more severe criminal charges than prior to 2009. The Department of Taxation and the various Attorneys General are also vested with new resources to identify and prosecute persons engaging in tax evasion.

Under pre-2009 law, the failure to file a tax return constituted a felony only if the taxpayer willfully and with an intent to evade tax failed to file for three consecutive years. Tax Law §1801(a) created a new crime, that of "tax fraud," which applies to all forms of tax evasion, whether accomplished by non-filing, false filing or other fraudulent scheme. The law now recognizes eight categories of tax fraud, starting with a class A misdemeanor, and rising to a class B felony. For purposes of comparison, homicide is also a class B felony.

Under prior law, taxpayers were generally required to have acted "willfully" in order to have committed a crime. However, most tax statutes did not define the term. Under present law, the term "willfully" is defined; and it creates a uniform minimum mental state required to commit a tax crime. Tax Law §1801(c), adopting the federal standard, defines the term "willfully" as "acting with an intent to defraud, intent to evade the payment of taxes or intent to avoid a requirement of [the tax law], a lawful requirement of the commissioner or a known legal duty."

II. Eight Categories of Tax Fraud

New York has eight "categories" of tax fraud, each contemplating varying degrees of punishment for the alleged tax offense, ranging from misdemeanors to serious felonies carrying with them the distinct possibility of long periods of incarceration. There is considerable overlap among the categories of tax fraud, so that in many cases, more than one statute could apply to one particular alleged offense. None of them is pleasant.

Tax Law § 1801(a)(1): Willful Failure to File a Return or Other Required Document

Under former tax law, the failure to file income or corporate tax returns constituted a felony only if the taxpayer failed to file for three consecutive years. Under present law, felony liability attaches if the taxpayer (i) fails to file (even for a single year); (ii) intends to evade tax; and (iii) underpays in an amount that meets the monetary threshold. Accordingly, any willful non-filer who intends to evade tax and evades more than $3,000 in tax liability could face felony prosecution.

Tax Law § 1801(a)(2),(3): Willfully and Knowingly Making or Filing a False Return or Report or Supplying False Information

Tax Law §1801(a)(2) provides that tax fraud occurs when a person willfully, while knowing that a return, report, statement or other document under that chapter contains any materially false or fraudulent information, or omits any material information, files or submits that return, report, statement or document with the state or any political subdivision of the state.

Tax Law §1801(a)(3) addresses the submission of false information to The Department of Taxation. Thus, a person commits tax fraud if he willfully and knowingly supplies or submits materially false or fraudulent information in connection with any return, audit, investigation, or proceeding or fails to supply information within the time required by or under the provisions of the tax law or regulations.

The scope of the provision is as vast: Nearly every conceivable materially false tax filing or submission could theoretically fall within the ambit of §1801(a)(2) and (3). Section 1801(a)(3), which addresses submissions to the Department, includes oral submissions made in connection with an audit or investigation. Thus, the intentional submission of false documentation by the taxpayer or by his representative would constitute a false submission. So too would the false assertion by the taxpayer (or his representative) made to an auditor or investigator concerning the existence or non -existence of records.

Tax Law §1832(b) makes clear that tax professionals who knowingly provide false documents or who make false assertions on behalf of taxpayers during audit face accomplice liability and will be subject to the same penalties as the taxpayer.

Under pre-2009 law, knowingly filing a false income or corporate tax return with intent to evade tax constituted a class E felony if the filing resulted in a "substantial understatement" of tax." Under present law, the threshold for a substantial understatement was increased from $1,500 to $3,000. Felony liability now arises where a materially false submission has been made with an intent to evade a tax or to defraud where the false submission results in a tax evasion of more than $3,000.

Provisions of the Tax Law complement, but do not supersede, existing Penal Law provisions. Under the Penal Law, knowingly filing a false document with any public office or public servant constitutes a misdemeanor, which rises to felony status if the false filing is made with an intent to defraud the state or any political subdivision. No minimum monetary threshold applies to the Penal Law statute. Thus, a taxpayer who files a false income tax return which defrauds New York of less than $3,000 would not be exposed felony liability under the Tax Law, but could be charged with a felony liability under the Penal Law.

Tax Law § 1801(a)(4): Willfully Engaging in a Scheme to Defraud the State in Connection With Any Matter Under the Tax Law

Tax Law §1801(a)(4) supplements §§1801(a)(2) and (a)(3) by ascribing tax fraud status to acts which do not involve filing a false document or making a false submission to the Department but nevertheless involve

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elements of fraud and scienter. Thus, §1801(a)(4) provides that a person (not necessarily a taxpayer) commits tax fraud when he "willfully engages in any scheme to defraud the state or a political subdivision . . . by false or fraudulent pretenses, representations or promises as to any material matter, in connection with any tax imposed. . ."

Although employing language similar to that found in the Penal Law, the Tax Law is more severe in that it does not require a "systemic ongoing course of conduct," as does the Penal Law. However, at the same time the Tax Law is more lenient than the Penal Law in that false representations must be with respect to a "material" matter.

This statute is apparently intended to reach persons engaging in schemes such as cigarette tax evasion that do not necessarily involve the filing of returns or the remission of taxes. Tax Law §1801(a)(4) is also apparently intended to act synergistically with new classes of tax felonies, described below.

Tax Law § 1801(a)(5): Willfully Failing to Remit Taxes Collected on Behalf of the State

Withholding taxes collected from employees and sales taxes collected from customers constitute trust fund taxes. While fiduciaries who misappropriate these funds have always been subject to prosecution under the Penal Law for larceny, prosecution under the Tax Law had been problematic, since prosecution of employers who failed to remit employment taxes was limited to a misdemeanor charge, regardless of the amount of payroll taxes collected and not remitted; and the failure of a tax vendor to remit collected sales tax was not a criminal act under the Tax Law.

However, Tax Law §1801(a)(5) now provides that tax fraud occurs when a person willfully "fails to remit any tax collected in the name of the state or on behalf of the state . . . when such collection is required under this chapter." Therefore, resort to the Penal Law is no longer necessary to seek felony prosecution for crimes involving failure to remit sales or withholding taxes.

Tax Law § 1801(a)(6): Willfully Failing to Collect a Sales, Excise or Withholding Tax That is Required to Be Collected

Under former tax law, the failure of employers to collect employment tax, and the failure of vendors to collect sales tax, constituted a misdemeanor. The failure to collect $10,000 in sales tax, or the failure to collect $100 in sales tax on ten or more occasions, constituted a class E felony. Tax Law §1801(a)(6) now provides that the willful failure to collect tax when required constitutes tax fraud *per se*. If taxes not collected exceed $3,000 in one year, felony liability attaches; otherwise, misdemeanor liability attaches.

Tax Law § 1801(a)(7): Willfully and With an Intent to Evade Any Tax, Failing to Pay a Tax Due

Tax Law §1801(a)(7) provides that a taxpayer who willfully and with intent to evade tax fails to pay such tax commits tax fraud. The present law imposes a stricter standard for prosecution than the pre-2009 law in that the failure to pay must be both willful **and** possess an intent to evade tax. This protects taxpayers who file but cannot pay the tax from potential criminal liability.

However, for those taxpayers whose failure to file does meet the more exacting standard, felony liability may attach if the amount of the underpayment exceeds specified thresholds. Apparently, this provision is intended to provide prosecutors with an avenue of recourse to punish those taxpayers who actually file accurate sales or income tax returns but who fails to pay those reported tax liabilities, if there was an underlying intent to evade tax, even if the taxpayer was unable to pay the tax. This provision is eerily reminiscent of debtor's prison, a draconian concept abolished in New York in 1832. One wonders if this violates the U.S. Constitution.

Tax Law § 1801(a)(8): Issuing False Exemption Certificates

Tax Law §1801(a)(8) provides that a tax fraud act includes one where a party willfully issues an exemption certificate, an inter-distributor sales certificate, a resale certificate, or any other document capable of evidencing a claim that taxes do not apply to a transaction, which he or she does not believe to be true and correct as to any material matter, which omits any material information, or which is false, fraudulent, or counterfeit.

Under present law, (i) a willful omission in an exemption certificate constitutes a violation of law and (ii) felony liability can attach (previously only misdemeanor liability arose) if the taxpayer possesses the intent to evade tax and as a result of the fraudulent act underpays an amount which meets the monetary thresholds specified in the felony tax fraud sections.

III. Felony Tax Fraud Classes

For the aforementioned provisions of the Tax Law to result in a consummated act of tax fraud, and to constitute a felony under the Tax Law, three separate requirements must be met:

First, the taxpayer must act willfully; that is, the taxpayer must intend to commit the prohibited act.

Second, the taxpayer must possess an intent to defraud New York. (Thus, merely intending to commit the prohibited act is not enough. The taxpayer must intend to commit the prohibited act and that act must be in furtherance of an intent to defraud New York. Thus, for example, a taxpayer who mistakenly believes that he was not required to file a tax return and

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had no intent to defraud New York would appear not meet the required threshold.)

Third, the tax liability must meet certain monetary thresholds.

The chart below summarizes the monetary thresholds required for various classes of tax felonies. A comparison is made with felony classification of other nontax crimes. For example, tax evasion in am amount exceeding $50,000 and armed robbery are now Class C felonies. Another departure from previous tax law is that a taxpayer engaged in income or corporate tax evasion in amounts exceeding $10,000 will now be exposed to serious felony liability.

Those committing sales or withholding tax evasion crimes have long been subject to felony prosecution for larceny under the Penal Law. Taxpayers filing a false return, but who fail to reach the $3,000 monetary threshold for being charged with a Class E felony, could still be prosecuted under the Penal Law for "Offering a False Instrument for Filing," which is a class E felony.

Tax Fraud Amt.			Nontax Equivalent
E	4th	> $3,000	DWI
D	3rd	> $10,000	Burglary
C	2nd	> $50,000	Robbery
B	1st	> $1,000,000	Homicide

IV. Other Considerations

In determining a particular class of tax felony, tax liabilities evaded within a single-year period may be aggregated, but not those occurring over more than one year. However, this limitation applies only with respect to aggregation under the Tax Law. Aggregation of sales tax or withholding tax liabilities over multiple years may occur where larceny prosecution is commenced under the Penal Law.

Tax Law §1800(c) imposes monetary penalties for tax felonies in amounts which are the greater of (i) double the amount of the underpaid tax liability or (ii) $50,000 for individuals or $250,000 for corporations. Fines for misdemeanors relating to tax fraud are $10,000 for individuals and $20,000 for corporations.

Under subsection (m) of Criminal Procedure Law §20.40(4), the taxpayer may be prosecuted in the county where the economic activity to prosecute the tax crime arose. This statutory change from pre-2009 law results from the assumption that taxpayers may be involved in economic activity in one county that results in the filing of a tax return in a different county.

Tax Law §1831 makes the willful failure to comply with a subpoena issued by the Department of Taxation a misdemeanor. Previously, misdemeanor liability attached to the willful failure to comply with some, but not all, administrative subpoenas issued by the Department.

Tax Law §32 now requires tax preparers who are not licensed attorneys or CPAs to register with the Department as tax preparers and to sign every return which they prepare. Under Tax Law §1833, failure to register or to sign a return constitutes a misdemeanor.

V. Conclusion

The Tax Law provides New York tax authorities with a vast arsenal of weapons to counter tax fraud. The Department of Taxation has in effect become a "new IRS" at the state level. Accordingly, tax professionals should be prepared to defend taxpayers not liable for tax fraud against possible acts of overreaching under the new law by the Department, the Attorney General, or by local prosecutors.

The New York legislature, a democratically elected body, has made a decision to impose severe criminal sanctions on dishonest taxpayers. The criminal sanctions imposed under the tax law prosecute and impose punishment for crimes which are undeniably *malum in se.* Yet, one can legitimately question whether the amalgam of tax statutes which operate to impose the same criminal sanction against one guilty of tax fraud involving $51,000 and a person who has committed armed robbery is fair. The felony characterization of the current tax law might violate both the Due Process Clause of the Fourteenth Amendment and the prohibition against cruel and unusual punishment of the Eighth Amendment.

Just as the Rockefeller drug laws of the 1970's were repudiated in later years for imposing inappropriately severe sanctions for certain drug-related crimes, the possibility that a taxpayer convicted of tax fraud could now face incarceration for a lengthy number of years for a white collar crime not involving violence or theft is, at least to some, disturbing. It seems incongruous that a person who defrauds New York even by $1 million has committed a crime of the same moral turpitude as a person who commits premeditated murder.

In fairness to the Legislature, it should be noted that federal sentencing guidelines have also mandated longer prison terms for those guilty of tax fraud. Until 1987, most taxpayers convicted of criminal tax violations against the United States received probationary sentences. Under Federal Sentencing Guidelines, effective for tax crimes after November 1, 1993, taxpayers found guilty of federal tax crimes also stand an increased likelihood of being incarcerated for some period of time.

FIDUCIARY COMMISSIONS, CONT.

(Continued from page 1)

$200,000, 3 percent on the next $700,000, 2-1/2 percent on the next $4,000,000 and 2 percent on any amount above $5,000,000. Executor commissions are in addition to the reasonable and necessary expenses actually paid by the Executor.

Executor Commission Base

In general, any asset which the fiduciary takes under his administration, and with respect to which he assumes a risk, would be included in the decedent's estate for calculation of the fiduciary's commission. Damages recovered in court actions by the personal representative are general assets of the estate subject to full commissions. [29 Carmody-Wait 2D §168:19].

The value of non testamentary assets (such as joint property, life insurance payable other than to the estate, and Totten Trust accounts) are not included in the commission base. Property transferred by the decedent in his lifetime in trust is also not part of the testamentary estate, and not included in the commission base.

However, if the assets of a trust are paid to the estate or used to pay claims, expenses, taxes or other estate charges, those assets will be subject to commissions. Commissions are based upon amounts received and amounts paid out, with one-half of the Commission being attributable to each. Paying and Receiving Commissions together represent one full Commission.

Advance Payment of Commissions

Executor commissions are paid after administration of the estate upon the settlement of the account of the fiduciary under SCPA §2307(1). SCPA §2310 and §2311 permit advance payment of executor commissions by application and approval of the Surrogate's Court. A fiduciary may request an advance payment on account of commissions to which the fiduciary would be entitled if he were then filing an account. Commissions paid to an Executor are considered taxable income, and must be reported on the Executor's income tax return.

II. Trustee Commissions

Annual Commissions

Trustees are entitled to annual commissions as well as commissions based upon amounts paid out. SCPA §2309(2) provides that Trustees are entitled to annual Commissions at the following rates:

(a) $10.50 per $1,000 or major fraction thereof on the first $400,000 of principal.

(b) $4.50 per $1,000 or major fraction thereon on the next $600,000 of principal.

(c) $3.00 per $1,000 or major fraction thereof on all additional principal.

Annual commissions may be computed either at the end of the year or, at the option of the Trustee, at the beginning of the year; provided, that the option selected be used throughout the period of the trust. The computation is made on the basis of a 12-month period but is adjusted upward or downward for any payments made in partial distribution of the trust or the receipt of any new property into the trust within that period.

SCPA §2309(3) further provides that annual commissions shall be paid one-third from the income of the trust and two-thirds from the principal, unless the will or trust otherwise directs.

Commissions Based Upon Sums of Money Paid Out

In addition to annual commissions, SCPA §2309(1) provides for Trustee Commissions to be paid on the settlement of the account:

> On the settlement of the account of any trustee under the will of a person dying after August 31, 1956, or under a[n] [inter vivos] trust . . .the court must allow to him his reasonable and necessary expenses actually paid by him . . . and in addition it must allow the trustee for his services as trustee a commission from principal for paying out all sums of money constituting principal at the rate of 1 per cent. Therefore, the trustee is entitled to a commission of 1 percent.

Annual Accounting to Beneficiaries

Trustees are required to furnish annually as of a date no more than 30 days prior to the end of the trust year to each beneficiary currently receiving income, and to any other beneficiary interested in the income and to any person interested in the principal of the trust who shall have made a demand therefor, a statement showing the principal assets on hand on that date and, at least annually, a statement showing all receipts of income and principal during the period including the amount of any commissions retained by the trustee.

SCPA §2309(4) provides that a trustee shall not be deemed to have waived any commissions by reason of his failure to retain them when he becomes entitled thereto; provided however that commissions payable from income for any given trust year shall be allowed and retained only from income derived from the trust during that year and shall not be supplied from income on hand in respect to any other trust year.

III. Effect of Multiple Trustees on Commissions

Assume that the will of John Smith names three Trustees. The following paragraphs discuss the effect of multiple trustees on the determination of trustee commissions.

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FIDUCIARY COMMISSIONS, CONT.

(Continued from page 12)

Effect of Multiple Trustees on Amounts Paid Out

SCPA § 2309(6)-(a) provides that, "subject to 2313," if the gross value of the trust exceeds $400,000 and there is more than one trustee, each trustee is entitled to full compensation for paying out principal allowed herein to a sole trustee unless there are more than three.

Effect of Multiple Trustees on Annual Commissions

A. Trust Principal $400,000 or more

SCPA § 2309(6)-(b) provides that, "subject to 2313," if the value of the principal of the trust for the purpose of computing the annual commissions allowed amounts to **$400,000 or more** and there is more than one trustee, each trustee is entitled to a full commission allowed to a sole trustee unless there are more than three trustees. If there are more than three trustees, the compensation to which three trustees would be entitled must be apportioned among the trustees according to the services rendered by them respectively unless the trustees agree in writing to a different apportionment. However, no such agreement may provide more than one full commission for any one trustee.

B. Trust Principal Between $100,000 and $400,000

If the value of the principal of the trust is between $100,000 and $400,000, each trustee is entitled to a full commission unless there are more than two trustees, in which case commissions must be apportioned according to the services rendered, unless the trustees shall have agreed in writing otherwise and which shall not provide for more than one full commission for a single trustee.

C. Trust Principal Less Than $100,000

If the value of the trust principal amounts to less than $100,000, one full trustee commission must be apportioned among all trustees according to the services rendered.

IV. Tax Considerations

Although one serving as fiduciary is entitled to receive fiduciary commissions, doing so will result in taxable income. If the estate is not subject to estate tax, then the receipt of fiduciary commissions may create taxable income where such taxable income might otherwise not be required. Where the fiduciary is not a beneficiary, there would no reason for the fiduciary to waive commissions. However, if the fiduciary is also a beneficiary, then waiver of fiduciary commissions might make sense.

The reason for this is that amounts received by reason of gifts or inheritance are not subject to income tax under IRC §101. Thus, bequests and legacies, either by reason of inheritance under a will, or as a beneficiary of a testamentary trust, will not be subject to income tax.

[Of course, income earned on the principal paid outright as a bequest after the death of the decedent will be subject to income tax. So too, income earned by a trust created by the will of the decedent will be subject to income tax either at the trust level or at the beneficiary level depending upon whether it is distributed to the beneficiary. Note also that the principal of a trust, or the principal distributed outright following the death of the decedent, will never be subject to income tax.]

On the other hand, commissions received by a beneficiary or any other person serving in a fiduciary capacity are subject to income tax. If the commissions are waived, then there is no commission to be subject to income tax. Since bequests and legacies are not subject to income tax, no work done by the fiduciary will be subject to income tax.

Although it is true that amounts paid to a fiduciary are deductible expenses that may be taken either on the estate tax return or on the fiduciary income tax return, there may be little or no benefit to taking these deductions, either because there is little or no estate tax, or the value of the deduction to the estate for fiduciary income tax purposes would be small.

Where several children are the beneficiaries of an estate, and one is the fiduciary, consultation among the beneficiaries is the best way to resolve whether or to what extent executor or trustee commissions should be waived.

TAX PLANNING FOR DIVORCE, CONT.

(Continued from page 1)

spouse. A common example would be a professional license. In *O'Brien v. O'Brien*, 66 NY2d 576 (1985), the Court of Appeals held that a professional license or the value of a professional career constitutes marital property. The trend of the cases expands the concept of marital property and circumscribes that of separate property.

Some qualification is necessary: Even though property may begin its life during marriage as separate property, it may be transformed into marital property upon the occurrence of an event. For example, if separate property is retitled during marriage, it will become marital property. Another act that will result in the creation of marital property is the comingling of assets.

The issue of whether property is commingled is one of fact. A prenuptial agreement may clarify whether specific property is or is not separate property. If no prenuptial agreement is in place, then it is especially important for that separate property not be commingled, if an important objective of the spouse is to preserve the nature of separate property. If, for example, a spouse applied an inheritance to purchasing a marital residence, the residence would by virtue of taking title to the property jointly, become marital property.

Another important point regarding the character of separate property relates to the distinction between separate property and the appreciation in value of separate property during marriage: Although the **property itself** may be separate property, **appreciation in the value of separate property** may be **marital property.** In general, passive appreciation in separate property will not cause that property to transmute into marital property. However, the **active participation** of a spouse in connection with the business of separate property may cause the **appreciation on the property** to become marital property.

In *Price v. Price*, 69 NY2d 8 (1986), the Court of Appeals held that where separate property has increased in value because of the efforts of the titled spouse, the non-titled spouse may claim some of the appreciation through that person's "contribution or efforts," including being a parent and homemaker.

It is important to remember that the equitable distribution law is the default rule. As in other legal contexts, the parties are free to alter the default rule by executing a prenuptial or postnuptial agreement. However, prenuptial agreements are made to be challenged, and one entering a marriage in New York should be aware that New York courts have shown little tolerance for, and have refused to place a judicial *imprimatur* on, not only agreements that are unconscionable, but also on agreements which are not unconscionable *per se*, but are the product of one-sidedness in the negotiation process. The element of surprise is also a factor which could militate against the enforcement of an otherwise unobjectionable prenuptial agreement.

One method of fortifying the asset protection intended by a prenuptial agreements is to utilize a trust funded by a parent, or by utilizing a self-settled trust established in another jurisdiction, such as Delaware or Nevada, that recognizes the right of a settlor to establish a self-settled spendthrift trusts. New York does not recognize the validity of self-settled spendthrift trusts.

II. Income Tax Planning

Income tax planning in the context of divorce requires familiarity with IRC §§71 and 215.

Under IRC §71, alimony payments are includible in income of the recipient spouse. IRC §215 grants the paying spouse a corresponding deduction. However, designating a payment as "alimony" is not sufficient to invoke the tax treatment of Sections 71 and 215. For alimony payments to be deductible by the paying spouse for federal income tax purposes, the following requirements must be met: (i) the payment of cash must be received pursuant to a divorce or separation agreement; (ii) the payments must cease upon the death of the receiving spouse; (iii) the payments must not be for child support; and (iv) the payments may not be "front loaded."

Still, IRC §71 provides divorcing spouses with considerable flexibility. By structuring support obligations to continue beyond what would normally be a terminating event, difficulties associated with illiquid marital estates may be resolved. Or, if parties contemplate that payments should diminish as children mature, the regulations provide a safe harbor preventing the application of IRC §71(c), which would otherwise nullify the deduction by recharacterizing the payment as one for child support. The structuring of alimony payments thus presents an opportunity to achieve a fair and tax-favored result for both parties.

The Nature of Property Transfers Between Divorcing Spouses

The Code addresses the issue of whether property transfers between divorcing spouses are subject to income tax, or are gratuitous transfers potentially subject to gift tax. In general, Congress has decided to grant divorcing spouses a tax pass. With proper planning, most transfers between divorcing spouses should not result in income tax liability, nor should they result in the transfer being subject to the gift tax.

Note that we are not speaking of alimony or child support **payments,** which indeed have income tax consequences. IRC §61(a), which imposes income tax on all income from whatever source, but rather the taxation of **property transfers** incident to the divorce, such as the transfer of a marital residence, which could conceivably result in a sale or exchange under IRC §1001(a), resulting in capital gain under IRC §1221 if the property is a cap-

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ital asset, or ordinary income under IRC §61, if it is not.

IRC §1041(a) speaks to the issue of whether the property transfer between divorcing spouses results in a "sale or exchange," which would require calculation of gain or loss under IRC §1001. Section 1041(a) provides that no gain or loss is recognized on the transfer of property between spouses, or between former spouses, provided the transfer is "incident to divorce." We therefore know from the clear statutory language of IRC §1041 (a) that no transfers made between married spouses are subject to income tax. This seems fairly intuitive.

But Section 1041(a)(2) adds that the same benign rule applies to "former spouses," *provided the transfer is incident to divorce.* For a transfer to be "incident to divorce," IRC §1041(c) requires that the transfer must occur "within 1 year after the date on which the marriage ceases," **or** "[be] related to the cessation of the marriage."

What about the language in IRC §1041(b) that pushes transfers not subject to income tax into a basket of transfers potentially subject to gift tax? Of primary importance is the realization that the donee spouse will take a transferred basis in the property, courtesy of IRC §1015. This is fair; there is no reason why Congress would grant a step up in basis to assets received by a divorcing spouse.

What about the status of the transfer as a taxable gift? If the divorcing spouses are still married in the taxable year of the transfer, the gift will qualify for the unlimited marital deduction under IRC §2523. The Code makes no distinction between divorcing spouses who have not yet been granted a divorce decree and spouses who are happily married.

If the spouses are already divorced, the marital deduction will be unavailable, yet IRC §1041(b) in this case is mostly a paper tiger, since properly structured transfers between even divorced spouses will find sanctuary either in IRC §2516 or from some element of consideration. As we know from contract law, consideration exists in many forms. We will return to the gift tax issue later.

Turning back to the income tax, recall that transfers made within one year of the date on which the marriage ceases are protected by the statutory safe harbor found in IRC §1041(c)(1). However, the one year safe harbor rule may be difficult to meet.

The take-away from this is that for income tax purposes, transfers between spouses not getting divorced, or who are not yet divorced, or who are divorced but have been divorced for no more than a year, or who have been divorced for more than a year but with respect to which the transfer "is related to the cessation of the marriage," will not be subject to the income tax by reason of IRC §1041. To determine whether this somewhat vague statutory requirement is satisfied, reference must made to the Treasury Regulations.

Treas. Reg. §1.1041-1T, Q &A 7 provides that a transfer of property "is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation agreement . . . and the transfer occurs not more than 6 years after the date on which the marriage ceases." The regulation adds that "any transfer not pursuant to a divorce or separation agreement and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage."

The presumption may be rebutted by proof showing that the transfer was not made within the prescribed time period because of factors which "hampered an earlier transfer . . . such as a legal or business impediment," and that transfer was "effected promptly after the impediment to transfer [was] removed."

Interestingly, the IRC §1041(c)(1) clearly states that a transfer is incident to divorce if it occurs within one year after the cessation of the marriage. The statute imposes no further requirement. The regulation takes a different view: It provides that "any transfer not pursuant to a divorce or separation agreement . . . is presumed not to be related to the cessation of the marriage.

This inconsistency could be reconciled if one assumed that the Regulation is only referring to transfers not made within the one-year period of the divorce. However, if Treasury had intended this meaning, it would have been to accomplish in so many words. Therefore, the conflict between the statute and the regulation is not insignificant.

Since IRC §1041 does not expressly direct Treasury to implement regulations in furtherance of the statute, the regulations under Section 1041 are "administrative regulations." Administrative regulations are less authoritative than "legislative regulations," which are drafted by Treasury pursuant to a directive contained within the statute itself. In addition, it might be argued that regulations which appear as "questions and answers," as does Treas. Reg. §1.1041-1T, might be less authoritative than regulations not drafted in question and answer form.

In any event, the safest route for divorcing spouses would be not to rely on the language of Section 1041(c)(1) which blesses transfers between divorced spouses within one year as being "incident to divorce," but to memorialize the transfer in a divorce or separation agreement in order to satisfy the stricter requirement found in the regulations.

Retirement Plans

Retirement benefits, like most other property acquired during marriage, may be subject to equitable distribution. Qualified retirement plans themselves are subject to a plethora of requirements imposed by the Internal Revenue Code, and the simple act of dividing a retirement account between divorcing spouses would violate sundry qualified plan rules established in

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Code Sections 401 through 409 since qualified pension plans are required to contain anti-alienation provisions. The loss of qualified status for a retirement plan would be devastating for tax purposes. For this reason, Congress has carved out an exception to the qualified plan rules that would otherwise preclude divorcing spouses from transferring interests in retirement plans.

In accordance with federal law, a New York court may issue a "qualified domestic relations order" or QDRO, which will permit the severance of a qualified plan. If the Order meets federal tax requirements, the result will be that the retirement will be that the severance will be deemed not to violate Code provisions that would otherwise result in loss of qualified plan status. If property passes to a spouse without a QDRO, the distribution will be taxable to the account holder, and premature withdrawal penalties will apply if the account owner is under age 59½.

To be valid, a QDRO (i) must specify the amount or percent of benefits to be paid to the alternate payee and (ii) must not change the form of benefit or provide for increased benefits. The QDRO should state that the order is being established under New York Domestic Relations Law, and in accordance with IRC §414(p). Thus, the spouse may become a co-beneficiary of the retirement account.

IRAs & SEPs

The rules for transferring interests in IRAs and Simplified Employee Pension Accounts (SEPs) upon divorce are more lenient: No QDRO is necessary. IRC §408(d) expressly provides for transfers of IRAs between spouses, or between former spouses if made pursuant to a divorce or separation agreement. However, the divorce agreement must expressly state that "[a]ny division of property accomplished or facilitated by any transfer of IRA or SEP account funds from one spouse or ex-spouse to the other is deemed to be made pursuant to this divorce settlement and is intended to be tax-free under Section 408(d)(6) of the Internal Revenue Code."

If IRA funds are transferred to a spouse without proper memorialization in the divorce agreement, the funds will be immediately taxable to the IRA account holder and may again be subject to an early withdrawal penalty if the IRA account holder is under age 59½.

Residences

The transfer by a divorcing spouse of an interest in a residence will result in no income tax consequences under IRC §1041, provided the requirements discussed earlier are met. Nevertheless, the transfer may incur local transfer tax liability. *See* N.Y.C.R.R. §575.11(a) and *In the Matter of Tobjy*, NYC Tax Appeals Tribunal 93-2128 (1995). If the transfer is structured as a sale with interest payments, and the note is secured by the residence, the IRS has stated that the interest on the note may be deductible. PLR 8928010.

Divorcing spouses should also keep in mind IRC §121, which provides for a "rolling" two-year capital gain exclusion allowance of $250,000 per taxpayer resulting from the sale of a primary residence. If a highly appreciated primary spousal residence is sold during the tax year in which the parties are still married, a $500,000 exclusion will be available. However, once a divorce decree has been issued, the horse will already have left the barn, and only a single $250,000 of gain exclusion will be available under IRC §121. The loss of a $250,000 capital gains deduction by reason of the issuance of a divorce decree which does not taken into account the contemplated sale of a primary marital residence can be avoided by simply being aware of the requirements imposed by IRC §121.

The potential problem arising under IRC §121 illustrates the importance of timing in divorce planning. For example, planning is necessary to ensure that adverse tax consequences do not arise by reason of the inability to file a joint income tax return. No joint income tax return may be filed if the spouses are not married on December 31 of the taxable year.

Appreciated Marital Assets

If marital assets consist of properties with varying degrees of appreciation, equity would suggest that each party receive a mix of property with the same relative degree of built-in gain. If this is not possible (*e.g.*, one spouse retains the personal residence with a higher basis), the parties may wish to compensate the spouse who takes the lower basis property since the sale of that property will generate future capital gains tax. That compensation would not be gratuitous, and would therefore not be subject to gift tax. If the requirements of IRC §1041 were met, that compensation would also not be subject to income tax.

Other Income Tax Issues

It should be noted that IRC §1041 is narrowly defined to apply only to transfers between spouses themselves. Thus, the transfer by one spouse of shares of a closely held family entity would not be within IRC §1041 and would result in a sale and exchange with the normal attendant requirement of reporting capital gain or ordinary income on the exchange, depending upon the nature of the property transaction.

IRC § 1041 also overrides some familiar tax principles. For example, Rev. Rul. 2002-22 held that the assignment of income doctrine is inapplicable with respect to transfers of nonstatutory stock options or rights to deferred compensation between divorcing spouses. Instead, IRC § 1041 dictates the counterintuitive tax result that the recipient spouse will be taxed when the options are exercised or the deferred compensation is received.

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TAX PLANNING FOR DIVORCE, CONT.

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III. Gift Tax Planning

In property law, a completed 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 elements have been met is a question of local law.

Congress (and the IRS) has dispensed with the requirement of donative intent. Thus, although divorcing spouses are not generally altruistically inclined with respect to their spousal counterpart, transfers made pursuant to settlement agreements may nevertheless spawn gift tax issues. If spouses are still married, then transfers that would otherwise constitute taxable gifts will be neutralized by the full marital deduction available under IRC §2523.

A transfer between divorced spouses could cause one to be concerned that the gratuitous transfer could be subject to gift tax, since IRC §1041(b)(1) defines as a gift any transfer that is not a sale or exchange. No protection would be accorded by the marital deduction available to married spouses, since the spouses would no longer be married.

IRC §2516 provides a good measure of protection from adverse gift tax consequences by stipulating that

> where spouses enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement . . . to either spouse in settlement of his or her marital or property rights or to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

If IRC §2516 is inapplicable, the spouse may be able to argue that consideration existed for the transfer. Specifically, the spouse may be able to argue that no gift occurred because the spouse relinquished enforceable rights arising upon the dissolution of the marriage. Alternatively, if minor children are involved, the spouse could argue that the release of support obligations for the minor children supply the consideration necessary to eliminate the gift.

Finally, it should be noted that the lifetime gift tax exclusion for federal gift tax purposes is now $5.25 million dollars, and that New York has no gift tax. Therefore, the issue of whether the transfer constitutes a gift is less important today than previously.