TAX NEWS & COMMENT

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IRS MATTERS

Recent Developments

TAXPAYER ADVOCATE ISSUES 2014 REPORT

National Taxpayer Advocate Nina Olson recently issued a report detailing the issues on which the Taxpayer Advocate Service (TAS) will focus during the fiscal 2014 tax year. IR-2013-63. The Taxpayer Advocate is required by federal law to issue two reports annually directly to the House Ways and Means Committee and to the Senate Finance Committee without prior review by the IRS, the Treasury, the IRS Oversight Board, or the Office of Management and Budget.

In the June 26, 2013 Report, Ms. Olson expresses particular concern of the impact of cuts to the IRS budget on taxpayer services, taxpayer rights, and revenue collection. She

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FROM THE COURTS

SUPREME COURT DECLARES DEFENSE OF MARRIAGE ACT UNCONSTITUTIONAL

PROFOUND TAX IMPLICATIONS

The Supreme Court in *United States v. Windsor* declared unconstitutional a key provision of the Defense of Marriage Act of 1996 (DOMA). The Court held that Section Three of DOMA violated the due process clause of the Fifth Amendment, which guarantees every person equal protection of the law. 570 U.S. ___ (2013). The landmark decision will have a significant impact on federal tax law.

[*Section Three of DOMA defined marriage, for federal purposes, as a legal union between a man and woman, and prevented the federal government from recognizing marriage between same-sex couples* —

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FROM WASHINGTON

SECOND TERM BLUES VISIT PRESIDENT OBAMA

CONGRESS GRANTS ONE-YEAR REPRIVE FOR AFFORDABLE CARE PAYMENTS

President Obama has suffered a precipitous decline in his approval rating since late April, when that indicator was at 50 percent. Today, Mr. Obama enjoys the approval of only 45 percent of Americans. Rumblings have already been heard that Mr. Obama is a "lame duck" on account of his Syria debacle, and his failed bid to install Lawrence Summers as Fed Chief.

Tax Analysis

All of this at a time when inflation remains at under 2 percent, the unemployment rate continues to decline, the economy improves, the price of crude moderates, most of the world is at peace, and the stock mar-

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Income Taxation of Grantor Trusts

[This a condensed version of a Note analyzing Grantor Trusts, viewable at nytattorney.com.]

I. Introduction

Grantor Trusts are described in Sections 671 through 679 of the Internal Revenue Code. These provisions are vestigial in nature, since they were originally enacted to prevent the shifting of income. In *Helvering v. Clifford*, 309 U.S. 331 (1940), the Supreme Court held that the grantor

Income Tax Planning

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Probate

[This a condensed version of an article discussing Probate, viewable at nytattorney.com.]

I. Introduction

Probate is the process in which a will is "proved" to the satisfaction of the Surrogate and the named Executor is given the legal right and power to implement the terms of the Will. For a propounded will to be admitted, the Surrogate must determine whether the will was executed in accordance with formalities prescribed in the EPTL. If the decedent dies intestate

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OCTOBER COMMENT

Reverse Exchanges Under Rev. Proc. 2000-37

[This is a condensed chapter from a treatise on Like Kind Exchanges, viewable at nytattorney.com.]

I. Introduction

Although the deferred exchange Regulations apply to simultaneous as well as deferred exchanges, they do not apply to "reverse" exchanges. In a reverse exchange, the taxpayer acquires replacement property *before* transferring relinquished property. Perhaps because they are intuitively

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FROM WASHINGTON, CONT.

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ket soars.

Mr. Obama need not lose too much sleep, however, because Americans feel even more disdain toward Congress, with fully 74 percent of Americans disapproving, and 19 percent approving, of the current performance of Congress. There is little doubt Americans are frustrated the inability of the White House to reach a deal with Congress to avoid sequester.

Nonetheless, the "threat" of sequester is much less alarming to Americans than it was only a few months ago. In March, 37 percent of Americans approved of the cuts that sequester would herald. As of September 15, 43 percent of Americans now actually favor the cuts. Treasury Secretary Jack Lew, in a speech before the Economic Club of Washington, on September 17, stated:

> Because of the policies that we've put in place, our deficit has fallen faster than at any point since the demobilization after World War II, and should continue to decline relative to GDP over the 10-year budget forecast.

Although the sheen on his Presidency may have faded with time, Mr. Obama is still considerably more popular at this juncture in his second term than was President Bush. In his quest to assert American dominance on the world stage, Mr. Obama seems to have taken a page from the foreign policy playbook of President Reagan. If Mr. Obama does avoid a debate with Congress on the use of military force against Syria, it may ironically be President Putin that rescued Mr. Obama from that dark fate.

On the domestic and economic front, Mr. Obama now appears more liberal than his mentor and advocate, President Clinton, but decidedly more conservative than the person who now appears to be the likely Democratic standard bearer in 2016, Senator Clinton. Although enormously popular among Democrats, Senator Clinton may be too liberal for a serious electorate, one concerned more about the economy and taxes than about social welfare, foreign policy, and global warming.

Should the Republicans nominate a moderate candidate hailing from north of the Mason-Dixon line, one more in the

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David graduated from Columbia Law School and received an LL.M. in Taxation from NYU. Formerly associated with Pryor Cashman, David is an approved sponsor with the NYS Board of Public Accountants, and frequently lectures to accountants and attorneys. He will be speaking in November at the Annual Tax Professionals Symposium at the Crest Hollow Country Club. David authored the treatise "*Like Kind Exchanges of Real Estate Under IRC § 1031.*"

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FROM WASHINGTON, CONT.

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mold of Lincoln than of Palin — perhaps a northern Republican such as Governor Christie, who could wrest some swing states from the Democrats, while likely returning New Jersey's 14 electoral votes — the Republicans could conceivably retake the White House in 2016.

* * *

Mr. Obama's major accomplishment — but at the same time almost his undoing — the Affordable Care Act, is beginning it troubled life in fits and starts. In June, the administration announced it was delaying for one year the commencement of mandatory employer responsibility payment and insurance reporting requirements implemented by the Act. The mandatory requirements for employers and insurers will now begin in January 2015 instead of 2014.

The Affordable Care Act requires companies with over 50 full-time employees to provide health insurance to their employees or pay a tax penalty of $2,000 per employee if the employee receives a premium tax credit for purchasing individual coverage on one of the upcoming health insurance exchanges. Employees that choose not to obtain health insurance will also have to pay a penalty.

In July, the House passed legislation that put the one year employer tax penalty delay into law and provides a similar reprieve with respect to employee obligations. Mr. Boehner (R—Ohio), the Speaker of the House, stated that the delay in the employer mandate was

> a clear acknowledgment that the law is unworkable [and that President Obama should recognize] the need to release American families from the mandates of this law as well.

Some provisions of the Act will begin as scheduled in 2014. Beginning next year, most Americans will be required to purchase minimum essential health insurance coverage, or pay a penalty. The penalty begins at $95 or 1 percent of income in 2014; rises to $325 or 2 percent of income in 2015; and plateaus at $695 or 2.5 percent of income in 2016. Taxpayers below the threshold for income tax filing, as well as those whose insurance would exceed 8 percent of income, are exempt.

Tax credits will be available to many taxpayers who purchase health insurance on state and federal "exchanges." In 2014, individuals earning up to $45,960, and families with household income of up to $94,200 will be eligible for the tax credits on a sliding scale.

* * *

Taxpayers should be keenly aware of the 3.8 percent surtax on net investment income enacted as part of the Affordable Care Act. The tax affects individuals with more than $200,000 in modified adjusted gross income (MAGI), and married couples filing jointly with more than $250,000 of MAGI. Only investment income above the income threshold will be subject to the tax.

The tax covers a broad swath of investment income, including dividends, taxable interest, net capital gains, passive income from investments, net rental income, and the taxable part of non-qualified annuity payments. Investment income does not include tax-exempt interest from municipal bonds or bond funds, or withdrawals from retirement plans such as IRAs, Roth IRAs, 401(k)s or qualified annuities. Although withdrawals from retirement plans are not taxable, taxpayers should be aware that income reported from those withdrawals constitute taxable income. Therefore, they will increase MAGI, possibly over the income threshold, causing other investments to become subject to the 3.8 percent tax.

One strategy taxpayers may employ to minimize the 3.8 percent tax is to avoid reaching the income threshold by reducing MAGI. Items that reduce AGI include itemized deductions (such as charitable donations) and deductible contributions to tax-favored retirement plans. Taxpayers may move a portion of income-generating investments (such as high-yield bonds) into tax-sheltered accounts (such as IRAs) to avoid reaching or exceeding the income threshold to which the tax applies.

Taxpayers should also consider the timing of their income. For example, if selling stock in December would trigger capital gain, it might make sense to defer the sale until the following tax year. Another method of avoiding taxable investment income would be to employ a Section 1031 like kind exchange. Through use of a like kind exchange, the taxpayer may exchange property of a "like kind" held productive use in a trade or for investment for other like kind property to be held for use in a trade or business or for investment, without triggering current gain.

* * *

Tax professionals have commented on "poor tax planning" that will cause the heirs James Gandolfini to pay millions in estate tax on the actor's $70 million estate. Mr. Gandolfini's will left 30 percent of his estate to each of his two sisters, 20 percent to his daughter, and 20 percent to his second wife. His son inherited a life insurance policy. Since the unlimited marital deduction applies only to the marital bequest, his estate will incur 30 million in combined federal and NYS estate tax.

Those critical of Gandolfini's planning observe that he could have left more to his second wife in trust, with the balance ultimately passing to his family. However, such a trust would have resulted in millions of dollars being left to accumulate — perhaps for decades — until Gandolfini's second wife passed away. Gandolfini's family would have received no benefit from the estate for many years.

Mr. Gandolfini instead chose to benefit those for whom he cared, despite incurring an estate tax obligation. Although there may have been other effective means to reduce his estate tax — and persons with an estate of that size should not forego careful planning — Gandolfini chose to incur the tax rather than defeat his testamentary desires.

FROM THE COURTS, CONT.

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even marriages recognized in the state where the same-sex couple resided. Same-sex couples were denied many tax advantages and benefits that opposite-sex couples enjoyed.

Windsor involved a same-sex married couple residing in New York, a state that recognizes same-sex marriage. In 2009, Edith Windsor's wife, Thea Spyer died and left her entire estate to Windsor. Windsor claimed a marital deduction for amounts she inherited. The IRS rejected the claim for deduction and assessed a deficiency, which Windsor paid. After her refund claim was rejected, commenced suit in the Southern District of New York, asserting that DOMA violated her rights under the Fifth Amendment. The District Court declared Section Three of DOMA unconstitutional. The decision was affirmed by the Second Circuit, after which the case was appealed by the government to the Supreme Court, which heard the case on a Writ of Certiorari (review of lower court's judgment for reversible error where no appeal as of right is available.)

Justice Kennedy, writing for the 5-4 majority, declared Section Three of the statute unconstitutional, as it "interfere[d] with the equal dignity of same-sex marriages, conferred by the States in exercise of their sovereign power," and "identif[ied] and [made] unequal a subset of state-sanctioned marriages." Chief Justice Roberts filed a dissenting opinion, arguing that the Supreme Court lacked jurisdiction to review the case.]

Federal Tax Implications

A plethora of tax provisions based on marriage status must be reexamined in light of *Windsor*. On August 29, 2013, IRS released Revenue Ruling 2013-17, which clarified some of the issues raised by tax professionals in connection with *Windsor*.

An important question put to rest by the Ruling was whether federal recognition of same-sex marriage for tax purposes will extend to individual couples based on state of celebration (state where the marriage occurred). *Windsor* involved a couple who lived in a state that recognizes same-sex marriage. Thus, *Windsor* by its terms would apply only to a married same-sex couple living in a state that recognizes same-sex marriage.

The IRS typically looks to the laws of a taxpayer's state of residence, rather than the state of celebrity to determine whether he or she is married for federal tax purposes. For example, if a same-sex couple marries and lives in New York (a state that recognizes same-sex marriage) but moves to Florida (which does not) the couple could lose recognition of their marital status for federal tax purposes. Such a policy would constrain same-sex couples from moving freely between states.

Rev. Rul. 2013-17 revolves this quandary by announcing that *Windsor* will apply to same-sex couples for federal tax purposes based on state of celebrity, regardless of whether the couple lives in a jurisdiction that recognizes same-sex marriage or in a jurisdiction that does not recognize same-sex marriage.

A second question resolved by the Ruling was whether *Windsor* applies retroactively, such that a legally married same-sex couple may file an amended return for past years to claim a federal tax refund. The Ruling states that all legally married same-sex couples may, but are not required to, file an original or amended return choosing to be treated as married for federal tax purposes for one or more prior tax years still open under the statute of limitations.

Legally married same-sex couples who could benefit from filing as married rather than single should consider consulting a tax professional to file amended returns for a refund. IRC §6511(a) permits taxpayers to file claims for refunds on overpayments of tax within the later of three years from the date the return was filed, or two years from the time the tax was paid.

Tax Planning Implications

Filing jointly can be an advantage to some and a disadvantage to others. If both partners in a same-sex marriage have high taxable income, filing a joint return could result in higher taxes. However, filing jointly may result in tax savings for a married same-sex couple in which one spouse has high income and the other has low income. Before *Windsor*, same-sex couples married under state law were required to file single file returns. Opposite-sex married couple have the option to file either joint or single returns. The potential advantage of filing jointly now extends to same-sex couples, at least on the federal level.

Prior to *Windsor*, legally married same-sex couples residing in a state recognizing same-sex marriage had an extra administrative burden when compared to opposite-sex couples. Since state tax returns often require a federal return as a starting point, same-sex spouses were required to prepare two federal returns. This was so even if the same-sex couple filed a joint return for state purposes.

Now that same-sex spouses must file as married for federal reporting purposes, this extra step is eliminated, and the playing field has been evened at the federal level for all married persons. Of course, same-sex couples may still file married filing separately if they wish to do so. State taxing authorities in States that do not yet recognize same-sex marriages will be required to decide how to process returns from same-sex married couple filing a joint returns for federal tax purposes. [13 jurisdictions recognize same-sex marriages: CA, CT, DE, IA, ME, MD, MA, MN, NH, NY, RI, VT, WA, DC & NM* (*some counties).]

Windsor may also provide large tax savings for couples selling their primary residence where one spouse holds title. A married coupled filing jointly can exclude up to $500,000 in capital gain. Before *Windsor,* the title-holding spouse would have been limited to an exclusion of $250,000.

When deciding whether to file jointly, taxpayers should also consider their combined capital gains and losses. Filing separately, if one spouse has

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high capital gains, that spouse would incur high income tax on those gains, whether or not the other spouse had capital losses. Filing jointly, however, could give the same-sex couple greater tax savings by allowing the capital losses of one spouse to offset the capital gains of the other spouse.

Federal recognition of same-sex marriages also alleviates problems which arose when a person provided health insurance to a same-sex partner. As a taxpayer filing singly, the health insurance benefit had been taxed as imputed income to the same-sex recipient. Now, employer payments for same-sex spouses will be treated as tax-free benefits provided to a spouse of an employee.

COBRA coverage and special enrollment rights provided under the Health Insurance Portability and Accountability Act (HIPAA) are now available to same-sex spouses on the same basis as they are to opposite-sex spouses. For example, a same-sex spouse will now also receive federal tax benefits conferred on spouses of federal employees.

Estate & Gift Tax Implications

The unlimited federal estate tax deduction for surviving spouses was the subject of the *Windsor* case. The upshot of *Windsor* is that married same-sex couples may also now claim the unlimited marital deduction for federal gift tax purposes. Thus, an individual may transfer property in any amount to his or her same-sex spouse during his or her lifetime free of federal gift tax, provided the recipient spouse is a U.S. citizen.

Before *Windsor*, any gratuitous transfer to a same-sex spouse was treated for tax purposes as a taxable gift. Consequently, property transferred by a taxpayer to his or her same-sex spouse reduced the applicable unified estate and gift tax exclusion amount of the donor spouse. That amount is currently $5.25 million. Now, since the gift may be deducted, the lifetime exclusion will remain undiminished.

Married same-sex couples may now also split gifts. Gift splitting will permit a same-sex married couple to leverage the lifetime exclusion by making an election on the federal gift tax return to treat gifts made by one spouse as being made one-half by each spouse.

Like their opposite-sex counterparts, the surviving spouse of a same-sex marriage may now also utilize portability to avoid wasting the gift and estate tax exemption. If portability is elected by the estate of the decedent spouse, the remaining portion of the $5.25 million lifetime exclusion may be transferred to the surviving same-sex spouse.

An individual may give an unlimited number of annual exclusion gifts every year, provided that only one annual exclusion gift can be claimed for any gift made to any one individual. The annual exclusion amount for 2013 is $14,000. A same-sex couple may now make an annual exclusion gifts of $28,000 to other individuals without reducing the lifetime gift tax exemption if the gift is split.

* * *

Steinbrenner Prevails Over IRS

In *U.S. v. Steinbrenner*, M.D. Fla, No. 8:11-cv-02840 (6/7/13), the IRS was soundly defeated in its attempt to recover a refund issued to New York Yankees co-owner and managing partner Harold Steinbrenner. The IRS had asserted that the taxpayer's demand for a refund was untimely.

Steinbrenner was a beneficiary of a family trust that was an indirect partner in YankeeNets, LLC through the intervening partnership Yankees Holdings, LP. To resolve a tax dispute, the IRS accepted a settlement agreement on March 1, 2007 with YankeeNets, LP. The settlement agreement resulted in loss adjustments to the partnership returns of YankeeNets, LLC and Yankee Holdings, LP. Consequently, a large net loss for the tax year 2002 flowed through to the trust and to its beneficiaries.

Steinbrenner, as a partner, paid the additional tax in June and October of 2008. The family trust amended the 2001 returns and claimed a net operating loss deduction for the 2002 return, which the trustee elected to carry back to the trust's 2001 return. This loss reduced the taxable income of the trust and its beneficiaries. In August, 2009, Steinbrenner claimed a refund for tax year 2001. The IRS issued a refund of $670,493.78 in late December, 2013. The IRS then sought to recover the refund, asserting that Steinbrenner's claim for refund had been barred by the statute of limitations.

IRC §6511(a) provides that the taxpayer must file a refund claim "within 3 years from the time the return was filed or 2 years from the time the tax was paid," whichever is later. Steinbrenner sought a refund within the 2 year time period from the date which he paid the tax.

The IRS asserted that as a refund "attributable to a partnership item," IRC §§ 6511(g) and 6230(c)(2)(B)(i) controlled. Read in conjunction, these two statutes provide that if a tax is attributable to a partnership item, the refund claim must be filed within 2 years of the day on which the settlement was entered. Under this limitation, Steinbrenner's refund claim would be untimely.

The Florida district court, in a somewhat caustic opinion, held that the carryback deduction taken by the trust was not attributable to a partnership item, and that the refund was indeed within the applicable statutory period for refunds. The court reasoned that neither the trustee, the family trust, nor the beneficiary was a party to the settlement agreement. Consequently, the overpayment was not governed by the settlement agreement between the IRS and the partnership.

* * *

Waiver of Partition Right Ignored

Estate of Elkins, 140 TC No. 5, involved the valuation of a 64-piece

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collection of artwork acquired by the decedent, James Elkins, Jr. and his wife during their marriage. The collection included works by Picasso, Paul Cezanne, and Jackson Pollack. After his wife's death, Mr. Elkins entered into a co-tenancy agreement with his children, which provided that the art could only be sold with the unanimous consent of all the co-tenants.

The Tax Court held that Mr. Elkin's agreement, in which he waived his right to institute a partition action with respect to some of the works of art, would be disregarded in valuing certain of the decedent's fractional interests in those works. This was so even though Elkins had relinquished an important right with respect to the art. The Court relied on IRC §2703(a)(2), which provides that the value of any property shall be determined without regard to any restriction on the right to sell or use the property.

The case appears to set the IRS back in its attempt to combat entity discounts, and may presage a wave of more damaging cases to the IRS, since Section 2703(a) has rarely been found relevant by courts when analyzing family entity discounts. On those occasions Section 2703 has been mentioned in decisions, it has generally been in the context of a Court rejecting an IRS attempt to limit a discount based upon restrictive provisions in an operating agreement.

* * *

Taxpayer Prevails in Annuity Case

Private annuities are a useful tool to transfer assets from a parent's taxable estate while providing income to the parent while he or she is alive. *Estate of Kite v. Commissioner*, TC Memo 2013-43 (Feb. 7, 2013), represents a taxpayer victory in utilizing a deferred private annuity between family members for planning purposes.

Mrs. Kite was ill in 2001 when she sold her interests in Kite Family Investment Co., a Texas general partnership, to her children pursuant to three private annuity agreements. The first payment was to occur in ten years. Mrs. Kite died three years later without her children having paid anything for their partnership interests.

The IRS argued that the transfer of the partnership interests for the annuity was a disguised gift with no real expectation of payment since Mrs. Kite's death was foreseeable. The Tax Court rejected this argument, finding that the decedent's medical expense deductions in the last three years of her life merely reflected that she was a wealthy woman who could afford home health care.

The IRS also argued that the annuity transaction was illusory. This argument was rejected as well, since the children possessed substantial assets that could have been used to make the payments. This was evidenced by a contribution of over $13 million in assets that the children made to the partnership before the agreements were executed. Therefore, the children were not relying on the assets they were buying in order to make the annuity payments.

* * *

Brooklyn Union Gas Loses Appeal

Matter of Brooklyn Union Gas Company v. NYS Tax Appeal Tribunal, App. 3rd, (NYLJ 6/12/2013) involved an Article 78 proceeding to review a determination by the Tax Appeals Tribunal that denied a refund of an investment tax credit under Tax Law article 9-A. The issue was whether certain property of Brooklyn Union, a public utility that provides natural gas to customers in NYC and Long Island, was "principally used by the taxpayer in the production of goods by manufacturing [or] processing."

Brooklyn Union claimed that its system was principally used to process natural gas from an unstable state to a safe and usable product for customers. Nevertheless, the Tax Appeals Tribunal found that the equipment was principally used to distribute and deliver natural gas, not to produce a product.

The Third Department affirmed the Tribunal's determination as having a rational basis. The integrated system was primarily one of distribution and delivery, as the vast majority of the 11,000-mile system is comprised of pipes and mains through which natural gas flows with no material change to the gas. The individual component parts did not change the nature of the gas but only counteracted changes caused by the storage and transportation of the gas.

The case reflects the difficulty which taxpayers encounter when appealing decisions of the administrative tax tribunal in an Article 78 Proceeding. Not only are taxing statutes narrowly construed, but the standard of review in an Article 78 proceeding is extremely narrow, permitting reversal only where the lower tribunal's decision either lacked a rational basis or was arbitrary and capricious.

* * *

IRC §199 Deduction Upheld

In *U.S. v. Dean*, 2013 WL 2255254 (C.D. Cal., 2013), the IRS asserted a claim for refunds that had been previously issued based on a deduction under IRC §199. The Section 199 deduction is available for businesses that perform domestic manufacturing, and was established by the Jobs Creation Act of 2004.

The issue was whether the act of packaging pre-sealed food items to create a gift basket was an act of "manufacturing" within Section 199. The court took an expansive view of the term "manufacture," and held that the gift baskets qualified for the deduction because the company changes the "form of an article," producing something that is "distinct in form and purpose from the individual items inside." Therefore, the items inside the gift basket were transformed from ordinary grocery store items to a gift usually given during the holiday season.

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notes that funding for employee training has been cut by 83 percent since fiscal year 2010 and recommends that funding be restored so that IRS employees may obtain the education and professional skills they require to administer the tax system in a manner that respects taxpayers' rights.

The Report states that the Advocate intends to focus on the following challenges facing the IRS during 2014:

(i) Relief to victims of tax return preparer fraud for financial harm suffered;

(ii) Adequate oversight of the tax return preparer industry;

(iii) Provision of effective, timely and taxpayer-centric relief to victims of identity theft;

(iv) Utilization of effective and timely collection alternative to minimize taxpayer burden while reducing the number and dollar amount of balance-due accounts;

(v) Conducting education and outreach to taxpayers about their responsibilities under the Affordable Care Act;

(vi) Resolving erroneous revocations of the tax-exempt status of small § 501(c)(3) organizations and failure to provide them with a pre-revocation administrative appeal; and

(vii) Establishment of more reasonable "settlement initiatives" for taxpayers with legitimate reasons for overseas bank and financial accounts whose failure to file reports was merely negligent.

Olson also released a special report examining the use by IRS of questionable criteria to screen Section 501(c)(4) applicants for tax-exempt status (civil leagues or organizations). The report analyzes the factors that contributed to the use of questionable screening criteria and processing delays and offers 16 recommendations to address them.

The report offers four categories of contributing factors: (1) lack of guidance and transparency; (2) absence of adequate check and balances; (3) management and administrative failures; and (4) exempt organization "cultural difficulty" with the Taxpayer Advocate Service. She observes in the preface to the report that the exempt organization review processing delays violated 8 of those 10 taxpayer rights.

II. TIGTA Audit Report

The Audit Report of the Treasury Inspector General for Tax Administration ("TIGTA") recommends improvements on all aspects of IRS administration of the tax system. In its June Report, released on July 17, 2013, TIGTA praised the Taxpayer Protection Program for improvement of identity theft detection, but observed the need for further improvement of case processing controls.

The Taxpayer Protection Program reviews tax returns that are proactively identified by the IRS as potential identity theft and stops fraudulent refunds before they are issued. However, TIGTA found that case processing controls require strengthening to reduce the burden on taxpayers victimized by identity theft. Tests of identity theft cases showed that the controls worked but that training was insufficient.

TIGTA recommends that the IRS develop processes to ensure that required identity theft indicators are placed on taxpayer accounts and employees properly update the Account Management Services system with actions they take when working identity theft cases. TIGTA further recommends the development of timeliness measures to accurately track the length of time required to solve Tax Protection Program cases.

III. Proposed Regs on Employer Reporting of Health Insurance

In September, 2013 the Department of the Treasury and the IRS issued proposed regulations with respect to reporting requirements for insurers and employers under IRC §6056, enacted pursuant to the Affordable Care Act. Section 6056 requires large employers to report to the IRS information concerning their compliance with the employer shared responsibility provisions of Section 4980H of the Code as well as health care coverage they have offered to employees.

The proposed regulations provide that "applicable large employers" must file a Section 6056 information return with respect to each full-time employee. The regulations also specify the information required to be reported. Such information includes a certification as to whether (i) the applicable large employer offered to its full-time employee the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, (ii) the number of months during the calendar year for which coverage under the plan was available, and (iii) the number of full-time employees for each month during the calendar year.

The proposed regulations also describe a variety of options to potentially reduce or streamline information reporting. These include: (i) replacing section 6056 employee statements with Form W-2 reporting on offers of employer-sponsored coverage to employees, spouses, and dependents; (ii) eliminating the need to determine whether particular employees are employed as full-time employees if adequate coverage is offered to all potentially full-time employees; and (iii) allowing employers to report the specific cost to an employee of purchasing employer-sponsored coverage only if the cost is above a specified dollar amount. The Treasury Department is accepting public comment on the proposed regulations through early November.

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IV. Summer 2013 Statistics of Income Bulletin

The Statistics of Income Division of the IRS recently issued its quarterly Statistics of Income Bulletin. The report provides the earliest published annual financial statistics obtained from the various tax and information returns. The report reviewed wage income and elective retirement contributions from Form W-2 for tax years 2008 through 2010. According to the report, average W-2 income rose less than 1 percent from $40,532 in 2008 to $40,892 in 2010. Between 2008 and 2010, men earned more on average than women; however, women reported an increase in their average W-2 earnings and men reported a decline. In 2010, almost half of all taxpayers with W-2 income participated in an employer-sponsored retirement savings plan.

The report also reviewed sole proprietorship returns in 2011. In 2011, there were approximately 23.4 million individual income tax returns that reported nonfarm sole proprietorship activity, a 1.8 percent increase from 2010. Profits reported on these returns rose 5.6 percent from 2010. The largest percentage of total profits, 25.6 percent, was reported by the professional, scientific, and technical services sector. Total receipts increased 5.9 percent from 2010. The largest sole proprietorship industrial sector, based on business receipts, was retail trade.

The report also includes statistics on foreign recipients of U.S. income in 2010. In 2010, foreign persons received $557.8 billion in U.S.-source income, as reported on Form 1042-S, a 2.1 percent increase over the amount received in 2009. Altogether, residents of the United Kingdom, Japan, Germany, Cayman Islands, Switzerland, France, Luxembourg, Canada, the Netherlands, and Belgium accounted for 74.2 percent of the U.S. income paid to foreign persons in 2010.

The report also discusses foreign domestic corporations in 2010. Foreign-controlled domestic corporations represented merely 1.3 percent of all U.S. corporation income tax returns filed in 2010, yet accounted for 15.5 percent of the receipts and 14.1 percent of the assets reported on all U.S. corporation income tax returns. Foreign-controlled domestic corporations owned by persons located in the United Kingdom reported the most total receipts, $0.9 trillion and 21.8 percent of total receipts.

The IRS reported on the use of the Empowerment Zone and Renewal Community Employment Credit for tax years 1998 through 2010. Federal empowerment zones and renewal communities are economically distressed geographic areas eligible for temporary tax incentives to encourage economic development. The amount of allowable credit claimed on individual and corporate tax returns increased from $41.7 million in 1998 to $277.1 million in 2005, then declined to $172.9 million in 2010.

V. IRS Interest Rates for Fourth Quarter 2013

The IRS has announced that certain interest rates it imposes would remain unchanged for the fourth quarter of 2013, beginning October 1. The rates are computed from the federal short-term rate determined during July 2013 to take effect Aug 1, 2013, based on daily compounding. The interest rates will be (i) three percent for overpayments (two percent for corporations); (ii) three percent for underpayments; (iii) five percent for large corporate underpayments; and (iv) 0.5 percent for the portion of a corporate overpayment exceeding $10,000.

VI. Form 990 Available Again After SSN Leak

In July 2013, the independent transparency and public-domain group Public.Resource.org discovered and exposed that the IRS had mistakenly failed to redact tens of thousands of Social Security numbers from forms posted on its public database filed by Section 527 political organizations, including Form 990. The offensive database was removed within 24 hours and the IRS suspended the production of copies of the Form 990 to third-party groups as required under law.

The IRS announced on September 4, 2013 that after an internal review, the IRS has resumed making the Form 990 series filed by exempt organizations available to third-party groups. The IRS has determined that there is low risk of Social Security numbers being included in Form 990 filings. The IRS will periodically conduct a statistically valid sample of new Form 990s to ensure that the risk remains low and will reassess its decision to release data based upon this review. The Service also reminded exempt organizations not to include Social Security numbers or other unnecessary personal information in the filings.

VII. Final Regs on Foreign Tax Credit Promulgated

The IRS has issued final regulations for determining the amount of taxes paid for purposes of the foreign tax credit (T.D. 9634). The Regs finalize proposed regulations issued in 2011 with no substantive change. The regulations primarily affect affiliated groups of corporations that have foreign operations. The regulations provide that amounts paid to a foreign taxing authority that are attributable to a "structured passive investment" arrangement are not treated as an amount of tax paid for purposes of the foreign tax credit.

Structured passive investment arrangements are designed to exploit differences between U.S. and foreign tax law by artificially creating a foreign tax liability that allows the U.S. party to claim a U.S. foreign tax credit and a foreign counterparty to claim a duplicative foreign tax benefit. The U.S. and foreign parties share the cost of the purported foreign tax payments through pricing of the arrangement.

TAXATION OF GRANTOR TRUSTS, CONT.

(Continued from page 1)

who had retained the right to control principal distributions to his spouse, who was the beneficiary of the trust, was the owner of the trust for income tax purposes. The enactment of IRC §§ 671 through 679 were codified as subpart E of subchapter J of the Code in 1954.

Justice Douglas, writing for the Court in *Helvering v. Clifford* emphasized the control which the grantor had retained over trust assets, manifested in the aggregate of indirect benefits and legal rights which the grantor had retained.[1] The trek through Sections 673 through 679 in search of such powers that cause the grantor to be taxed on the trust income therefore have as guideposts benefits, both direct and indirect, retained by the grantor, as well as legal rights so retained.

II. Computing Grantor's Income

IRC §671 provides that the grantor of a grantor trust reports "the items of income, deductions, and credits" attributable to the portion of the trust which is a grantor trust. With respect to wholly grantor trusts, the grantor's tax year and accounting method will carry over to the trust. Since the grantor of a grantor trust is taxed on trust income, a grantor trust is squarely within the species of "disregarded entities" for purposes of the federal income tax.

However, under the "Portion Rule," if only a portion of the trust is a grantor trust, the remaining portion will be a nongrantor trust, taxed under the taxing provisions for trusts found in Subparts A through D of Subchapter J.

To illustrate the above principal, assume first that the trust is a wholly grantor trust by reason of the grantor's retention of a right to trust income. In this case, the grantor will be taxed on all items of income, deduction and credit of the trust under IRC §§ 674(a) and 677(a).

Next, assume that the grantor is the owner of only one asset of a trust that owners several assets. If that asset were, for example, rental property, the grantor would be taxed on all items of income, deduction, and credit "directly related" to the rental property. Treas. Regs. § 1.671-3(a)(2).

Finally, assume that the trust provides that the grantor is the owner of the "ordinary" income of the trust. [The grantor trust rules provide that when the term "ordinary" precedes income, the term ordinary income refers to fiduciary accounting income; conversely, when the term "income" is used by itself, the term refers to taxable income.] In this case, the grantor would be taxed on the fiduciary accounting income of the trust, and would be permitted to deduct expenses allocable to income and principal. The grantor would not be taxed on capital gains of the trust. Treas. Regs. §1.671 -3(b)(1). In addition, the grantor's reportable income could not exceed the "distributable net income" of the trust. Treas. Regs. §1.671-3(b)(1).

III. Relation to Estate Tax

Though in some circumstances retained powers sufficient to cause grantor trust status will also cause a transfer to be incomplete for transfer tax purposes, the rules for determining whether a complete transfer has been made for income tax purposes or for transfer tax purposes are different. For example, the retention by the grantor of an administrative power to substitute trust assets of equal value will result in grantor trust status. Nevertheless, without more, such a retained administrative power would not cause the transfer to be incomplete for transfer tax purposes. Conversely, some transfers may be complete for income tax purposes, but incomplete for transfer tax purposes. In those cases, the trust would be taxed on its income, but no gift will have been made. An important is determining whether a trust should be a grantor trust or a nongrantor trust, and then drafting the trust to achieve that objective.

IV. Section 672 — Definitions and Rules

672(a) An "adverse" party is any party 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. A person having a general power of appointment over the trust has a beneficial interest in the trust.

672(b) A "nonadverse" party is a person who is not an adverse party.

672(c) A "related or subordinate party" means a nonadverse party who is (i) the grantor's spouse or (ii) the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the trust are significant from the viewpoint of voting control; and a subordinate employee of a corporation in which the grantor is an executive. For purposes of IRC §§674 and 675, a related or subordinate party is presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred upon him unless such party is shown not to be subservient by a preponderance of the evidence.

672(d) A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent of giving notice or takes effect only on the expiration of a certain period after the exercise of the power.

672(e) A grantor shall be treated as holding any power or interest held by (A) any individual who was the spouse of the grantor at the time the power or interest was created; or (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor. An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall

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not be considered as married.

V. Powers Causing Grantor Trust Status

Sections 673 through 679 detail those powers that will result in the grantor being deemed the tax owner of the trust. In some cases, a person other than the grantor will be considered the tax owner of the trust; that circumstance is found in Section 678.

The grantor trust provisions are cumulative, due in part to the different dates of enactment. Grantor trust status will result if the grantor can be taxed under any statute. Conflicts seldom exist, but where they do, the statute provides guidance as to which provision trumps another. For example, a beneficiary may be taxed on the income under IRC §678 and a grantor under IRC §674. When this occurs, the grantor is deemed to be the person taxable on the trust income. The grantor trust provisions now include spousal attribution for most purposes. This is in sharp contrast to the estate tax provisions, which do not provide for spousal attribution.

To analyze these statutes, it is helpful to locate those sections that will trigger grantor trust status, but also to identify those provisions — sometimes in the same sentence — that will ferry the trust out of the grantor trust provisions.

Blue type indicates trust language that will cause the grantor to be treated as tax owner.

Red type denotes exceptions to the rule, wherein the trust will be taxed under Subparts A through D of Subchapter J, the normal trust tax rules.

Dark Blue type found in Section 678 denotes "Mallinckrodt" trusts, where someone other than the grantor — perhaps a trust beneficiary — is taxed on trust income.

Double underline type indicates where "toggling" between grantor trust and nongrantor trust status may be possible.

Finally, the bracketed symbols in black *e.g.*, [PEA], indicate who may exercise the referenced power in order to cause grantor trust status (*i.e.*, any person, or only the grantor, or the grantor or a nonadverse party, or a disinterested trustee.

KEY TO STATUTES:

BLUE = GRANTOR TRUST

RED = NONGRANTOR TRUST

DARK BLUE = MALLINCKRODT TRUST

DOUBLE UNDERLINE = TOGGLING CAPABILITY

KET TO ABBREVIATIONS FOR WHO MAY EXERCISE POWERS:

PEA = Power may be exercised by anyone

PEGNP = Power may be exercised By Grantor or Nonadverse Party

PEG = Power may be exercised only by the Grantor

PEIT = Power may be exercised only by an Independent Trustee

Section 673 – Reversionary Interests:

673 The grantor is treated as owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such reversionary interest exceeds 5 percent of the value of such portion.

Section 674 – Power to Control Beneficial Enjoyment [PEGNP]:

674(a) The grantor is treated as owner of any portion of trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any *adverse party*.

Exceptions to 674(a) – Grantor NOT treated as tax owner if anyone possesses these powers (subject to internal exceptions):

674(b)(1) A power to distribute income to discharge support obligation, except to the extent that the income is actually so applied. **[PEA]**

674(b)(2) A power to affect beneficial enjoyment only after occurrence of event such that the grantor would not be treated as the owner under IRC §673 if the power were a reversionary interest; but grantor may be treated as owner after the occurrence of event unless the power is relinquished. **[PEA]**

674(b)(3) A power exercisable only by will, other than a power in the grantor to appoint by Will the income of the trust where the income is accumulated or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. **[PEA]**

674(b)(4) A power to determine beneficial enjoyment of corpus or income if corpus or income if irrevocably payable for a charitable purpose under IRC §170(c). **[PEA]**

674(b)(5) A power to distribute corpus either (A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries provided the power is limited by a *reasonably definite standard*[19] in the trust instrument; or (B) to or for any current income beneficiary, provided the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary. **[PEA]**

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TAXATION OF GRANTOR TRUSTS, CONT.

(Continued from page 10)

674(b)(6) A power to withhold income temporarily, provided that any accumulated income must ultimately be payable (A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees, or (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust. **[PEA]**

674(b)(6) A power does not fall within the powers described if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after adopted children.
[PEA]; [TOGGLING]

674(b)(7) A power exercisable only during (A) the existence of a legal disability of any current income beneficiary, or (B) the period during which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. **[PEA]**

674(b)(7) A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.
[PEA]; [TOGGLING]

674(b)(8) A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language. **[PEA]**

Exception to 674(a) – Grantor NOT Treated as Tax Owner if Power is Possessed by Independent Trustee:

674(c) Grantor trust status shall not result from a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are *related or subordinate parties* who are subservient to the wishes of the grantor – (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).
[PEIT]; [TOGGLING]

A power does not fall within the powers so described if any person has a power to added to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born children.

For periods during which an individual is the spouse of the grantor (within the meaning of IRC §672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

Exception to 674(a) – Grantor NOT Treated as Tax Owner if Power to Allocate Income is Limited by Reasonably Definite External Standard

674(d) Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a *reasonably definite external standard* which is set forth in the trust instrument. **[PEIT]**

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. [TOGGLING]

Section 675 – Administrative Powers: Grantor treated as tax owner if Grantor Possesses these powers (subject to exceptions):

675(1) The grantor shall be treated as owner of any portion of a trust in respect of which there exists a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, enabling the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than adequate consideration. **[PEGNP]**

675(2) The grantor shall be treated as owner of any portion of a trust in respect of which there exists a power, exercisable by the grantor or a nonadverse party, or both, to borrow corpus or income, directly or indirectly, without adequate interest or without adequate security, except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. **[PEGNP]**

675(3) The grantor shall be treated as owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the (next) taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

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For periods during which an individual is the spouse of the grantor (within the meaning of IRC §672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.
[PEG]; [TOGGLING]

675(4) The grantor shall be treated as owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. A "power of administration" means one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to require the trust corpus by substituting other property of an equivalent value.
[PEA]; [TOGGLING]

Section 676 – Power to Revoke:

676 The grantor shall be treated as the owner of any portion of a trust where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both. **[PEGNP]**

Section 677 – Income for Benefit of Grantor:

677(a) The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under IRC §674, whose income without the approval or consent of any adverse party is, or, in the *discretion of the grantor or a nonadverse party, or both, may be* (1) distributed to the grantor or to the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of [insurance premiums].

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under IRC §673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.
[PEGNP]

Exception to Section 677 for Obligations of Support:

677(b) Income of a trust shall not be considered taxable to the grantor merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to maintain, except to the extent that such income is so applied or distributed.

Section 678 – Person Other Than Grantor Treated as Substantial Owner: (Malinkrodt Trust)

678(a) A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

678(b) Subsection (a) shall not apply with respect to a power over income, as originally granted, or thereafter modified, if the grantor of the trust or a transferor is otherwise treated as the owner under the provisions of this subpart other than this section.

678(c) Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain, except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

678(d) Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

678(e) For provision under which beneficiary is treated as owner of the portion of the trust which consists of stock in an S corporation, see IRC §1361(d).[4]

VI. Reporting & Compliance

Two methods are sanctioned by the Regulations for reporting income of grantor trusts.

1. Obtain TIN For Trust— (Preferred method)

Under the first method approved by the Regulations, the trustee obtains an EIN for the trust, and notifies all payors of income of the existence of the EIN for the trust. Forms 1099 must be sent by each payor to the

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Trustee, who in turn sends separate Forms 1099 to the grantor for each receipt of income. The trustee then files a blank Form 1099 fiduciary income tax return (stating on page one of the otherwise blank return, that the trust is a grantor trust and that income is being reported by the grantor) with a separate statement attached, disclosing the items of income, deduction, and credit attributable to the grantor of the trust (or portion of the trust, if the trust is not a wholly grantor trust.) This method, which is the most straightforward, and most common, may be used regardless of whether there is a single grantor, or there are multiple, grantors. In addition, since this is the only method in which a Form 1041 is actually filed, if the trust is part nongrantor trust, then this method must be used.

2. Form 1099 Methods

In the first variation of the 1099 method, the trustee furnishes to each payor the **grantor's name and tax identification number, and the address of the trust**. Upon receipt of each Form 1099, the trustee then forwards the Form 1099 to the grantor, who files the form If the grantor is not a trustee, the trustee must furnish the grantor with (i) an annual statement indicating items of income, deduction and credit for the taxable year; (ii) the identity of every payor; (iii) information sufficient to permit the grantor to properly report the income; and (iv) a statement advising the grantor that items must be included on the grantor's income tax return. **This method can only be used if there is a single grantor.** with the IRS.

Alternatively, the trustee may provide all income payors with the **name, taxpayer identification number, and address of the trust**. Here, the trust would itself file the Forms 1099 with the IRS. If the grantor is not a trustee, the trustee must furnish the grantor with (i) an annual statement indicating items of income, deduction and credit for the taxable year; (ii) the identity of every payor; (iii) information sufficient to permit the grantor to properly report the income; and (iv) a statement advising the grantor that items must be included on the grantor's income tax return. **This method can only be used if there is a single grantor.**

VII. Turning Grantor Trust "On" and "Off"

In many cases, there may be no reason to consider changing the status of a trust from a grantor trust to a nongrantor trust, or vice versa. However, the ability to turn grantor trust status "on" and "off" has intrigued tax planners. It is possible that many existing trusts not drafted with the possibility in mind of changing the taxable status of trust may be pressed into service to accomplish the objective of changing the tax status of a trust. However, it would is far better to foresee the possibility that the trust may need to provide flexibility in this regard, and to actually draft trust provisions so as to allow the trust to shed its grantor trust status, or to transform into nongrantor trust.

For example, consider a sale of assets to a "defective" grantor trust, implemented for estate planning reasons. At some point, the grantor may decide that the cost of the venerable tax free gifts to the trust have become too expensive, and that he no longer wishes to be the tax owner of the trust. It will be necessary to take some action that will change the taxation of the trust. One method of accomplishing this could be for the grantor to borrow a sum of money from the trust in year one, and repay it in year two, utilizing IRC §675(3). Presumably, the trust would then be a grantor trust in year one, and a non-grantor trust in year two. It may also be possible to draft the trust in such a manner that an administrative power under IRC §675 (3), for example, "springs" to life upon the occurrence of an event or contingency, thus creating a grantor trust at some future time. Some have suggested that it may even be possible to "toggle" a trust so that grantor trust status can be turned "on" and "off." It remains to be seen how the IRS will view "toggling."

In Chief Counsel Advisory 200923024, the IRS stated that the conversion of a nongrantor trust to a grantor trust was not a realization event for income tax purposes. In the context of decanting, Notice 2011-101 requested comments from the public regarding possible income, gift, estate and Generation Skipping tax issues arising from transfers by a trustee of all or a portion of the principal of a distributing trust to an appointed trust. Among the thirteen "facts and circumstances" that the Treasury Department and the IRS have identified as potentially affecting one or more tax consequences, one involved the change from a grantor trust to a nongrantor trust:

> The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Internal Revenue Code (a "grantor trust") to one which is not a grantor trust, or vice versa.

A decanting which appoints assets held in a grantor trust to a nongrantor trust, or *vice versa*, could conceivably result in income tax consequences for the grantor and the beneficiaries of the new trust. In response to the invitation by the IRS for comment, the New York State Bar Association Tax Section, on April 26, 2012, issued Report No. 1265, entitled *"Report on Notice 2011-101: Request for Comments Regarding The Income, Gift, Estate and Generation-Skipping Tax Consequences of Trust Decanting."* In its Report, the New York State Bar stated its opinion that where the Distributing Trust transfers all of its assets to a Receiving Trust, the decanting should be considered a "non-event" for income tax purposes.

PROBATE, CONT.

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(without a will), the estate will still need to be administered in order to dispose of the estate to "distributees," those persons who take under the laws of descent in New York.

The proper venue for a proceeding to probate the will of a decedent domiciled in New York at the time of his death is the county in which the decedent was domiciled at that time. Although a probate proceeding may be brought in any county in the state, such proceeding will be transferred to the Surrogates Court with proper venue.

EPTL § 3-5.1 sets forth rules governing wills which have some relation to a jurisdiction outside of New York. For such a will to be admitted to probate in New York, it must be executed in accordance with local law formalities imposed by (i) EPTL § 3-2.1; (ii) the jurisdiction where the will was executed; or (iii) the jurisdiction where the decedent was domiciled at the time of executor or the time of death. The law of the forum state applies to issues of due execution. However, New York law governs issues of testamentary capacity, fraud and undue influence.

II. Will Must be Validly Executed

For a will to be valid, EPTL 3-2.1 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, know the nature of his estate and the natural objects of his bounty (*i.e.* "testamentary capacity"); (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 witness. 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.

The burden of proof that a will was executed in accordance with will formalities is on the proponent of the will. Where an attorney presides over a will execution, there is a presumption that will formalities have been adhered to. The threshold for testamentary capacity is low; a testator need not even have the mental capacity to enter into a contract in order to execute a valid will. However, one must be 18 years of age or older in order to validly execute a will.

For many reasons, it is important to draft a will. Without a will, all assets of the decedent that do not pass by operation of law must pass under the laws of descent. The decedent's wishes may or may not coincide with the laws of descent. Disputes among heirs may arise over who should serve as Administrator. Without a will, a public administrator may need to be appointed to dispose of the decedent's estate if no potential Administrator steps forth.

To be admitted to probate, the original will must be located. To ensure that the will is not misplaced during the life of the testator, the will may be filed with the Surrogates Court during the testator's lifetime. In the case of a missing will, the Surrogate has the power to grant an *ex parte* order for the examination of the decedent's safe deposit box to determine whether the will is located there.

If a will becomes lost or destroyed, it may be admitted to probate provided it is established that (i) the testator had not revoked the will; (ii) due execution is proved in the manner required for an existing will; and (iii) all of the will provisions are clearly proved by at least two credible witnesses, or by a copy or draft of the will proved to be true and complete.

If the original will has been lost, a procedure exists for the admission of a photocopy, but for obvious reasons, photocopies are disfavored by the court. Removing staples from an original will to copy or scan it is a poor idea, as New York Surrogates take a dim view of wills that are not intact. A will may also be admissible without will formalities having been adhered to under very limited circumstances applicable to persons involved in armed conflict or who are displaced over the high seas.

III. Propounding Will to Probate

Any person in physical possession of the will may propound it for probate. Indeed, one in possession of a will has an ethical, if not legal, obligation to propound the will. Any person with the legal right to file a probate petition may compel a person in possession of the will to produce it for probate. Such persons include legatees, devisees, fiduciaries, guardians, person interested in the decedent's estate under SCPA 103(3), a person entitled to letters of administration c.t.a. under SCPA 1418, as well as creditors.

The will must be accompanied by a Probate Petition, which must include an estimate of the size of the estate. The Petition must name all distributees and their relationship to the decedent. If the relationship to the decedent derives from another person who is deceased, the Petition must either state the name and relationship to the decedent of each person so deceased or provide a family tree describing the foregoing. If the only statutory distributees are of a more remote relationship than siblings of the decedent, the Petition must adduce proof that there are no persons who are of the same or nearer relationship to the decedent. If distributees are unknown, the Petitioner must submit an "Affidavit of Due Diligence," affirming that lack of knowledge.

Following the filing of a Probate Petition, Citations to appear before the Surrogate must be issued to all persons with a right to challenge admission of the will. Such persons include, but are not limited to, (i) distributees, (ii) the designated executor, and (iii) any person named as beneficiary, executor, trustee or guardian in any other will of the testator filed in Surrogates Court whose rights would be adversely affected by the instrument offered for probate.

Any adult person may waive

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the right to appear before the Surrogate by executing a waiver of Citation. Waivers signed by distributees must be filed with the Surrogates Court on or before the return date of the Citation. The Citation must state the name of the decedent, the name and domicile of the Petitioner, the names of persons to be served, the return date and place, and the nature of the relief sought (*e.g.,* issuance of Letters Testamentary), the date of issuance, and the name and address of the Petitioner's attorney. Service of Citation must be complete within 10 to 30 days of the return date, depending on whether or not the person may be served within New York.

The Petitioner must also mail a Notice of Probate to all persons named in the will who are not required to be served with a Citation. This will give those persons the opportunity to intervene in the probate proceeding. Such persons include legatees, devisees, trustees, guardians, and substitute or successor executors.

[Note that a "legatee" is someone who receives a bequest under the will. A legatee may or may not be a distributee. For example, a dog who receives a bequest would be a legatee, although not a distributee. However, it is doubtful that the Surrogate would require the a Notice of Probate be sent to the dog (unless perhaps if the dog were a border collie).

In order for a will to be admitted to probate, attesting witnesses to the will must appear in Surrogates Court if either (i) the witnesses did not execute a "self-proving" affidavit establishing the validity of the will and its execution, or (ii) the probate proceedings are contested. In the event a witness to the will has died, is absent from New York, or is incompetent, the Surrogate may dispense with the testimony of that witness, and allow the admission to probate of the will based upon the testimony of only one attesting witness.

IV. Issuance of Probate Decree

If the Surrogate determines that the will is genuine, executed in accordance with will formalities, and that the testator was competent, the Surrogate must admit the will to probate. Following admission of the will into probate, the Surrogate will issue a Decree of Probate and an Order directing that Letters Testamentary issue to the named Executor, and if applicable, that Letters of Trusteeship issue to any Trustee named under the will be issued. These Letters grant the fiduciary the power to engage in transactions involving estate assets.

[Note that if the trust was an *inter* vivos trust — either revocable or irrevocable — then no Letters of Trusteeship would be required. In that case, the Trustee would already have been acting, and the trust would not be within the jurisdiction of Surrogate's Court, unless and until an issue arose requiring the involvement of the Surrogate.]

Letters may not be issued to infants, incompetents, convicted felons, a person who lacks the qualifications required of a fiduciary (*e.g.,* due to substance abuse, dishonesty, improvidence, or want of understanding) and alien non-domiciliaries.

The Surrogate may, in his or her discretion, issue *Preliminary* Letters Testamentary if a delay in the admission to probate of the Will is expected. Preliminary letters confer upon the Executor all the powers of Letters Testamentary with the limitation that the Executor may not (i) make distributions from the Estate or (ii) sell specifically bequeathed property without the consent of the beneficiary. Preliminary letters may also impose other limitations, such as the necessity that the Executor furnish a bond, or the requirement that new Preliminary Letters be requested within a short time frame.

Executors and Trustees are fiduciaries whose duties are to faithfully administer the will or testamentary trust. If the will does not name an Executor or the named Executor fails to qualify, an Administrator c.t.a ("*cum testamenta annexo*") will be appointed and the Surrogate will issue Letters of Administration to that Administrator as fiduciary of the estate.

A nominated Executor must furnish the Surrogate with an acknowledged instrument stating the address of the Executor and designating the Surrogates Court as agent to receive service of process. The Executor must also take an oath that he will faithfully and honestly discharge the duties of his office. A person may renounce his appointment as Executor by filing an acknowledged written instrument with the Surrogates Court.

V. Challenging a Will

Any person whose interest in the estate of the decedent would be adversely affected by the admission of the will into probate may file objections to the probate of the will. Objections must be filed on or before the return date of the process or on such subsequent day as directed by then Surrogate.

Individuals with standing to object to the will being admitted include (i) the decedent's distributes (*i.e.,* those who would inherit if the decedent had died intestate) and (ii) any named beneficiary in the will. If an examination of the attesting witnesses is requested, objections must be filed within 10 days after the return completion of such examination, or within such other time as agreed to by the parties or imposed by the Surrogate.

To deter will contests, most wills contain an *in terrorem* clause, which operates to render void the bequest to anyone who contests the will. EPTL 3-3.5 provides that "[a] condition, designed to prevent a disposition from taking effect in case the will is contested by the beneficiary, is operative despite the presence or absence of probable cause for such contest, subject to [exceptions]." However, the existence of an *in terrorem* clause does not bar a person from challenging a will. In practice, *in terrorem* clauses tend to serve a deterrent effect.

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difficult to reconcile with the literal words of the statute, reverse exchanges were slow to gain juridical acceptance. An early case, *Rutherford v. Com'r,* TC Memo (1978), held that purchases followed by sales could not qualify under Section 1031.

However, *Bezdijian v. Com'r*, 834 F.2 217 (9th Cir. 1988) held that a good exchange occurred where the taxpayer received heifers in exchange for his promise to deliver calves in the future. Following B*ezdijian*, taxpayers began engaging in a variety of "parking" transactions in which an accommodator (i) acquired and "parked" replacement property while improvements were made and then exchanged it with the taxpayer ("Exchange Last"); or (ii) acquired replacement property, immediately exchanged with the taxpayers, and "parked" the relinquished property until a buyer could be found ("Exchange First"). Just as deferred exchanges were recognized by courts, so too, reverse exchanges soon received a judicial imprimatur.

There are two types of reverse exchanges: (i) non-safe harbor (pure) reverse exchanges and (ii) safe harbor reverse exchanges structured under Rev. Proc. 2000-37 (effective with respect to an EAT that acquires legal or beneficial title on or after September 15, 2000).

By qualifying under the safe harbor, a legal fiction is imposed that the taxpayer has not violated principles of constructive receipt or agency, which would otherwise doom the reverse exchange (as they would doom any exchange). In contrast, those proceeding under a non-safe harbor reverse exchange, venture into those waters at their own peril; issues of constructive receipt and agency are floating icebergs in the sea of the tax law which if triggered will doom the exchange. At times, protection of the safe harbor, while otherwise desirable, may not be possible, most likely because the taxpayer cannot comply with the stringent time constraints imposed under the safe harbor. Because of the tax risk, many companies operating as EATs will only structure reverse exchanges within the parameters of Rev. Proc. 2000-37.

II. Safe Harbor Reverse Exchanges

Safe harbor reverse exchanges provide a degree of certainty not possible using a non-safe harbor reverse exchange. However, time constraints imposed by Revenue Procedure 2000-37 may make qualification under the Ruling somewhat difficult. In that case, a non-safe harbor reverse exchange may be the only option.

To qualify under Revenue Procedure 2000-37, the an "Exchange Accommodation Titleholder" ("EAT") must be engaged to park either the relinquished property or the replacement property (depending upon whether the reverse exchange is structured as an "Exchange Last" or an "Exchange First" reverse exchange.)

The EAT must be the owner of property for federal income tax purposes. However, the EAT need not be the owner for other legal purposes (*e.g.,* local and state tax purposes). To be the "tax owner," the EAT must possess "qualified indicia of ownership" ("QIO") from the acquisition date until the date the property is transferred. This means that the EAT must possess (i) legal title; (ii) beneficial title under principles of commercial law; or (iii) interests in a disregarded entity that itself holds legal title to the property. The EAT need not either acquire any equity interest or assume any risk.

Rev. Proc. 2000-37 also stipulates that at the time legal title is transferred to an EAT, the taxpayer must intend that such transfer be part of an exchange intended to qualify under Section 1031. Although an EAT may be the Qualified Intermediary ("QI"), it cannot be a "disqualified person."

A disqualified person under Treas. Regs. § 1.1031(k)-1(k) is a person who is (i) an agent of the taxpayer; (ii) a person with whom the taxpayer bears a relationship described in either Section 267(b) or Section 707(b) (determined by substituting in each section "10 percent" for "50 percent"); or (iii) a person who bears a relationship described in (ii) to the agent of the taxpayer. Essentially, the rules parallel those for persons disqualified from acting as qualified intermediaries under the deferred exchange regulations.

Rev. Proc. 2000-37 also imposes certain time restrictions. First, the taxpayer must, within five days of transfer of title to an EAT, enter into a "Qualified Exchange Accommodation Agreement" ("QEAA"). The QEAA must provide that (i) the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37; (ii) the parties agree to report the acquisition, holding, and disposition of the property as provided for therein; (iii) the EAT will be treated as the beneficial owner of the property for all federal income tax purposes; and (iv) both parties will report the transaction in a manner consistent with the QEAA. The combined time period during which relinquished and replacement property may be held pursuant to the QEAA cannot exceed 180 days. Finally, with regard to "Exchange Last" reverse exchanges, the taxpayer must identify property to be relinquished within 45 days after transfer of title of the replacement property to an EAT.

A significant advantage of structuring the reverse exchange under Rev. Proc. 2000-37 lay in the permissible agreements which it allows between the EAT and the taxpayer. The taxpayer or a disqualified person may guarantee obligations of, or loan funds to, an EAT. The taxpayer may also lease the property from the EAT or manage the property. A safe harbor reverse exchange will not be destroyed if the taxpayer and EAT enter into a contract regarding the purchase and sale of property provided the contract is not effective for more than 185 after the EAT acquires the property. An

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EAT and the taxpayer may also enter into contracts that take into account the variation in value of relinquished property upon disposition by the EAT.

III. Non-Safe Harbor Reverse Exchanges

A reverse exchange may also be consummated outside of the safe harbor of Rev. Proc. 2007-37 when the exchange cannot be structured to comply with the time restraints imposed by the Procedure. Non-safe harbor reverse exchanges have no identification or exchange period requirements *per se*. However,

Pure reverse exchanges pose more tax risk. Issues of agency and constructive receipt which do not arise under the safe harbor may doom a non-safe harbor reverse exchange. For example, the IRS could argue that an accommodator was the taxpayer's agent. The success of a pure reverse exchange will therefore depend in substantial part upon whether the accommodator is respected as tax owner, or is deemed to be merely the taxpayer's agent. As a practical matter, non-safe harbor qualification may prove difficult if the transaction was originally intended to qualify under Rev. Proc. 2000-37.

IV. "Exchange First" Reverse Exchange

Whether a reverse exchange is structured under Revenue Procedure 2000-37 or outside of that safe harbor primarily concerns issues involving how long the accommodator or "EAT" may hold the property, and what types of transactions the EAT or accommodator may enter into with the taxpayer without violating issues of agency and constructive receipt. Whether or not the reverse exchange is consummated within the safe harbor, the relinquished property — or the replacement property — *must still be parked* with an accommodator such as an EAT. Either the relinquished property or the replacement property may be parked with the accommodator in a reverse exchange.

If it is necessary for the taxpayer to park the relinquished property, then the exchange will actually occur at the outset. This will constitute an "Exchange First" reverse exchange. Here, the EAT purchases the relinquished property from the taxpayer through the QI (steps into the shoes of the buyer). The relinquished property is "parked" with the EAT until the taxpayer closes on the purchase of the replacement property. Using exchange funds obtained from the EAT, the QI would then purchase replacement property which would be transferred to the taxpayer, completing the exchange.

The EAT may continue to hold the relinquished property for up to 180 days after acquiring title. During this time period, the taxpayer will arrange for a buyer. At closing, the EAT will use funds derived from the sale of the relinquished property to retire the debt incurred by the EAT in purchasing the relinquished property from the taxpayer at the outset. An advantage of the Exchange First reverse exchange is that the taxpayer may use the replacement property as collateral for a loan obtained by the EAT to purchase the relinquished property.

An Exchange First reverse exchange might be necessary where the prospective buyer of the taxpayer's relinquished property defaults and the taxpayer must take title to replacement property or risk losing the down payment.

V. "Exchange Last" Reverse Exchange

Alternatively, an Exchange Last reverse exchange may be utilized. Here, the EAT takes title to replacement property at the outset pursuant to the Qualified Exchange Accommodation Agreement with the taxpayer. This structure is typically employed when the taxpayer must close on the replacement property immediately and there is insufficient time to arrange for disposition of relinquished property such that a typical deferred exchange with a QI is not feasible.

For example, there may be competing bids to acquire the property or the replacement property may require improvement. Financing for the purchase may be arranged by the taxpayer or by the EAT itself. The EAT may hold title to the replacement property for no longer than 180 days. While parked with the EAT, the property may be improved, net-leased, or managed by the taxpayer.

The taxpayer must identify property (or properties) to be relinquished within 45 days of the EAT acquiring title to the replacement property, and the taxpayer must dispose of the relinquished property through the QI within 180 days of the EAT acquiring title. Following the sale of the relinquished property to a cash buyer through a QI, the QI will transfer the proceeds to the EAT in exchange for the parked replacement property. The EAT will direct-deed the replacement property to the taxpayer, completing the exchange. The EAT will use the cash received from the QI to retire the debt incurred in purchasing the replacement property.

The Exchange Last reverse exchange is preferable in certain respects. First, since the parked property will have been initially acquired by the EAT, there is little risk the EAT will be disregarded for tax purposes. In addition, following acquisition by the EAT of the replacement property, the taxpayer can consider several potential properties to be relinquished, and can ultimately choose that which defers the most gain. If the exchange is not completed within the 180 day safe harbor timeframe, the taxpayer can fall back to a non-safe harbor reverse exchange.

A build-to-suit reverse exchange would be definition always employ the exchange last format. While parked with the EAT, the property may be improved. If improve-

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ments cannot be completed within 180 days, a reverse exchange would not be structured under Rev. Proc. 2000-37.

V. Build-to-Suit Arrangements

Property may be improved or constructed while being "parked" with an accommodator, such as a qualified intermediary (QI) or exchange accommodation titleholder (EAT). In such build-to-suit arrangements, the taxpayer must avoid actual or constructive receipt of exchange proceeds. In a QI or QEAA safe harbor, legal fictions dispel issues involving agency and constructive receipt. The efficacy of build-to-suit arrangements outside of the QI or QEAA safe harbors depends on whether the accommodator has acquired sufficient "burdens and benefits" of ownership with respect to the parked property such that he is treated as the tax owner rather than as merely the taxpayer's agent. A build-to-suit arrangement may even be structured with a related party, provided that party is not an agent of the taxpayer.

If sufficient improvements to the replacement property can be made within the 180-day exchange period, and taking title to the replacement property before relinquishing property is not imperative, a deferred exchange under the Regulations would normally be structured. Construction would typically done by the QI. Note that the QI must (i) acquire title; (ii) pay for the improvements; and (iii) transfer the replacement property to the taxpayer prior to the end of exchange period. Regs. §1.1031(k)-1(g)(4) permits the QI to be the designated agent of the taxpayer. This may eliminate a second transfer tax and also facilitate construction financing. A QI could presumably pay construction costs incurred during the 180-day exchange period.

If construction can be completed within 180 days, but the taxpayer must take title to the replacement property to be constructed prior to relinquish property, the transaction cannot, by definition, be structured as a deferred exchange. Rather, an exchange last reverse exchange would be required. Since construction can be completed within 180 days, the safe harbor under Rev. Proc. 2000-37 would be employed. Under Rev. Proc. 2000-37, the taxpayer may exert considerable control over the improvements to the replacement property; more so than in a non safe harbor reverse exchange. That is, even though the EAT holds beneficial or legal title, the taxpayer may direct the EAT to construct improvements according to the taxpayer's specifications

If more than 180 days are required to construct improvements, the taxpayer may have no choice but to structure the transaction as a non-safe harbor reverse exchange – whether or not the taxpayer has an urgent need to take title to the replacement property, since only then can the taxpayer avoid the 180-day jurisdictional limitation imposed by Section 1031(a)(3)(B) for deferred exchanges and by Revenue Procedure 2000-37 for safe harbor reverse exchanges be avoided.[2] The accommodator in a non-safe harbor build-to-suit exchange should bear some risk of loss and incur some legal obligations.

VI. Conclusion

While providing benefits in many situations, a reverse exchange is a relatively costly tool due do the requirement that an "Exchange Accommodation Titleholder" (EAT) obtain legal title to the parked property. Accordingly, reverse exchanges should be used only when a deferred exchange is not feasible, such as where the purchaser of the relinquished property has defaulted, or where title must be taken to the replacement property immediately, before the taxpayer disposes of relinquished property.